



ICSA

INTERNATIONAL COUNCIL of SECURITIES ASSOCIATIONS

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**ICSA Working Group on Mutual Recognition:
Research Note on Promoting Mutual Recognition**

As the experience since the emergence of the financial crisis demonstrates, it is imperative to develop mechanisms for coordinating national regulatory policies in a more effective and efficient manner in order to ensure that those policies are consistent and coherent with one another. Mutual recognition between securities market regulators is potentially one policy tool that could be used to coordinate divergent national regulatory policies on a bilateral and multilateral basis, thereby ultimately leading to globally consistent regulatory policies in a variety of areas. In addition, mutual recognition also offers a potential means for enhancing capital market integration through more open assess and a closer alignment of regulatory policies, which in turn could contribute to increase efficiency and liquidity in those markets and increased rates of economic growth in the wider economies.

This Research Note has been developed by the International Council of Securities Associations (ICSA) as a way to contribute to the preliminary work that will be done by IOSCO's Task Force on Cross Border Regulation.¹ The Note presents an overview of various mutual recognition agreements that have been reached between securities market regulators over the past several decades in a variety of economies. In addition, the Note provides a number of suggestions that IOSCO's Task Force on Cross Border Regulation and IOSCO more broadly could examine to see if they could be helpful as a way to promote mutual recognition among securities market regulators.

¹ ICSA's members come from a broad range of jurisdictions and represent and/or regulate firms active in all of the major developed financial markets as well as a number of advanced emerging market economies. ICSA's objectives are: (1) to encourage the sound growth of the international securities markets by promoting harmonization in the procedures and regulation of those markets; and (2) to promote mutual understanding and the exchange of information among ICSA members. More information about ICSA can be found at: www.icsa.bz

A. Mutual recognition among securities regulators: a review

Mutual recognition for securities markets could be defined as a bilateral or multilateral agreement between securities market regulators under which each one recognizes the other's regulation and supervision of certain financial products and/or services and/or markets as an adequate substitute for its own. There are clear advantages to mutual recognition when compared to harmonization since under mutual recognition each individual regulatory agency that is party to the agreement is able to maintain their own policies and standards, once those are deemed to be sufficiently comparable to the policies and standards in effect in the other jurisdiction(s) that are signatory to the agreement. At the same time, however, mutual recognition agreements between securities market regulators are often part of a deeper economic integration process that in some circumstances may lead to regulatory harmonization.

The principle of mutual recognition clearly played an important role in the process of eliminating regulatory barriers to the common market in goods and services within the EU since the late 1980s, after several decades of promoting economic and financial integration through other measures. This principle was also present in the 1985 European Commission White Paper on reform of the internal market, which set out three basic principles to be followed in order to promote the free movement of financial services across the EU.² However, when mutual recognition proved to be insufficient to achieve financial market integration within the EU, measures to deepen the single market in financial services, beginning with the 1999 Financial Services Action Plan (FSAP), focused instead increasingly more detailed harmonization and centralized rulemaking for the financial services sector.

While mutual recognition has become considerably less important in the EU, during the past decade it has emerged as a major paradigm for stimulating increased economic integration and capital market development in Asia. Drawing on the painful lessons of the 1997/98 Asian debt crisis and the more recent global financial crisis, government officials throughout Asia have promoted regional integration as a means to develop their own capital markets while also lessening dependence on financing from Europe and the US. As part of that effort, securities market regulators throughout Asia are relying on mutual recognition on both a bilateral and

² Those principles were: (1) the harmonization of essential standards; (2) mutual recognition amongst the regulatory authorities; and (3) home country control.

multilateral basis and, in certain circumstances, regulatory standardization and harmonization as a way to encourage increased integration between national capital markets in the region, which in turn is expected to promote increased capital market efficiency, capacity and liquidity.³

Mutual recognition is, for example, a key component of the ambitious integration project that was agreed upon by the Association of Southeast Asian Nations (ASEAN) in 2007. Termed the ASEAN Economic Community Blueprint (AEC Blueprint), the agreement established a program for ASEAN to become a common market by 2015. In order to support the AEC Blueprint, the ASEAN Capital Markets Forum (ACMF), composed of capital market regulators for all ten ASEAN economies, prepared a roadmap for capital market integration within ASEAN. Known as the ACMF Implementation Plan, the initial phase of the plan focuses on establishing a network of bilateral mutual recognition and harmonization arrangements between capital market regulators within ASEAN. Once those arrangements are formed, the intention is to subsequently move towards multilateral arrangements as more ASEAN economies become ready to participate.

It is largely acknowledged that the ASEAN economies will not meet the ambitious timeline set out in the AEC Blueprint, due in part to the wide differences in levels of economic development within ASEAN, and have also been slow to move forward on the ACMF Implementation Plan.⁴ However, some significant measures have been implemented. In particular, in early 2013 Singapore, Malaysia and Thailand agreed to implement a revised set of harmonized disclosure standards for offerings of equity and “plain” fixed income securities issued from and sold to investors in any of the three jurisdictions on a cross-border basis. It is hoped that these ASEAN Standards, which are based on IOSCO’s standards for cross-border offerings, will eventually be adopted by all other ACMF members.⁵ In addition, the Thai Securities and Exchange

³ For a general overview of the rationale for this approach see Andrew Sheng (2008), “Mutual Recognition and Harmonization of Regulatory Standards in Asia: An Overview”, presentation made to the 9th OECD-ADBI Roundtable on Capital Market Reform in Asia held in Toyko, Japan. For a recent overview of the extent of regional integration of equity and fixed income markets in Asia see Cyn-Young Park (June 2013), *Asian Capital Market Integration: Theory and Evidence*, Asian Development Bank, ADB Economics Working Paper Series, No. 351.

⁴ Some elements of the ACMF Implementation Plan which have not yet been adopted include the development of a single passport system for financial market intermediaries, the development of a mutual recognition framework for primary offerings and for market professionals involved in primary offerings, and the development of harmonized criteria for non-retail investors.

⁵ There are two sets of ASEAN Disclosure Standards. The ASEAN Standards for the offerings of equity securities are based *IOSCO’s International Disclosure Standards for Cross-Border Offerings and Initial Listings by Foreign*

Commission (SEC) announced that it will allow ASEAN CIS to be offered to non-retail investors with the goal of extending the initiative to retail investors at a later stage. Similarly Singapore has also announced a proposal to develop a mutual recognition framework for retail CIS.

Mutual recognition is now also an important component of the Asian Bond Market Initiative (ABMI), which includes the ASEAN economies along with the People's Republic of China, Japan, and the Republic of Korea (known as ASEAN+3). ABMI was established in 2003 with the aim of developing more efficient and liquid local bond markets within the ASEAN+3 region while also encouraging the development of a regional bond market. As part of its overall mandate, ABMI members approved the establishment of the ASEAN+3 Bond Market Forum (ABMF) in 2010 in order to foster mutual recognition between securities regulators within the region along with the standardization of market practices and harmonization of regulations relating to cross-border bond transactions.⁶

During the current phase of its work, the ABMF is proposing the establishment of an ASEAN+3 Multi-Currency Bond Issuance Framework (AMBIF) in order to support intra-regional cross-border issuance of local currency bonds intended for sale to professional or qualified investors. The AMBIF will require that regulators in participating economies “mutually recognize” a set of standardized disclosure requirements as well as each other's regulatory processes for bond issuance and each other's definition of professional or qualified investors. The ultimate aim is to achieve regulatory harmonization for the professional or qualified investor bond market so that bond issuers in any participating economy within the ASEAN+3 are able to issue bonds in any other participating location with one set of standardized disclosure and mutually recognized regulatory process for bond issuance. It is expected that participation in the AMBIF will initially be on a bilateral basis with a multilateral agreement reached at a later date.

In order to develop the AMBIF proposal, the ABMF has spent a considerable amount of time considering how the regulatory recognition process should be implemented. It considered two approaches: (1) the proxy approach; and, (2) the substituted compliance approach. Under the proxy approach (PA), each regulator would accept the results of a regulatory process conducted

Issuers (1998). The ASEAN Standards for the offerings of debt securities are based on IOSCO's *International Disclosure Standards for Cross-border Offerings and Listings of Debt Securities by Foreign Issuers* (2007).

⁶ See Asian Development Bank (2012), *ASEAN+3 Bond Market Guide*.

by another regulator as valid for issuing bonds in its location (by an issuer from the corresponding location) without requiring any additional process. Under the substituted compliance approach (SCA) both a home regulator and host regulator would cooperate in processing a bond issuance by incorporating the results of the regulatory process conducted by one regulator into the regulatory process of the other regulator. Since the proxy approach would be difficult to implement at the current time given the wide differences between economic conditions in the ASEAN+3 economies, the ABMF has recommended that regulators adopt the substituted compliance approach. The ultimate goal, however, is for regulators throughout the region to adopt the proxy approach.

Mutual recognition is also a key component of the proposed Asia Regional Funds Passport (ARFP), which would allow eligible mutual funds from eligible jurisdictions within Asia to be marketed across borders with minimal additional host jurisdiction regulatory requirements.⁷ It is envisioned that the ARFP would begin with bilateral mutual recognition agreements between individual securities market regulators but in time would go beyond those to provide a multilaterally agreed framework that would allow the cross-border marketing of funds among a large number of Asian economies.⁸ Full development of the ARFP would involve, ultimately, agreement on a standardized set of licensing arrangements, investment restrictions and, potentially, offer conditions so that complying funds registered in one Passport economy could be offered in each of the other Passport economy.

Australia introduced the concept of the Asian Regional Funds Passport as an exploratory policy initiative within the Asia-Pacific Economic Cooperation Finance Ministers' Process (APEC FMP) in 2010. Since then, a series of policy dialogues along with technical and capacity building workshops have been held as technical details of the project were further developed and regional interest in the initiative deepened.⁹ It is expected that a high level technical model for a

⁷ In essence this would be an Asian version of the EU's UCITS (Undertakings for the Collective Investment of Transferable Securities) which, once registered in a single EU member state, can be easily marketed across the EU and to other jurisdictions outside of the EU.

⁸ Development of the Passport would also require putting in place mechanisms for the continued administration of the systems at the national and the regional level. Some countries, including China, have already begun to lobby to be the host of the regional administrator for the ARFP.

⁹ The Australian Treasury in collaboration with the Australian Securities and Investment Commission (ASIC) is the lead agency responsible for facilitating the development of the ARFP within the APEC Finance Ministers Process.

pilot ARFP project will be presented to APEC Finance Ministers during their September 2013 meeting in Bali. Although the pilot may not begin for some time, Australia, Hong Kong, Japan and Singapore, the so-called Pathfinder economies, are expected to be the initial participants in the pilot program once it is initiated.

It is apparent that these ambitious multilateral programs within Asia are, to a certain extent, both interrelated and building off of one another. There is, for example, a strong similarity between ultimate objectives of the proposed ASEAN+3 Multi-Currency Bond Issuance Framework (AMBIF) and the proposed Asia Regional Funds Passport (ARFP). There are also similarities between certain elements of the ACMF's Implementation Plan and both the AMBIF and the ARFP. This is not surprising, since many of the same regulators are involved in discussions and negotiations about some or all of these projects. In short, a common understanding about the usefulness of capital market integration has emerged within the region and the individuals involved in the various initiatives are learning from one another about how they can best be implemented.

In addition to these ambitious multilateral projects, regulators in a number of economies within Asia have also developed bilateral mutual recognition agreements with one another. For example, in addition to the stillborn mutual recognition agreement reached with the US in 2008, Australia has also negotiated a mutual recognition agreement with Hong Kong that allows for cross-border offerings of CISs and has been in talks for some time about the same type of mutual recognition agreement with Singapore.¹⁰ In addition, Hong Kong and Taiwan have a bilateral mutual recognition agreement that also allows for cross-border offerings of CISs. Perhaps most importantly, earlier this year regulators from Hong Kong and mainland China announced that they had established a working group to discuss the development of a mutual recognition platform for the cross-border sale of collective investment schemes between the two economies. If the proposed mutual recognition scheme is eventually approved, as is expected, it could

¹⁰ In addition to the mutual recognition agreements discussed here, Australia and New Zealand have been involved in a long-term effort to enhance economic integration between the two economies. Collectively known as Closer Economic Relations (CER), the two countries have removed virtually all restrictions on the movement of goods and most services through an extensive array of agreements and arrangements including joint agencies and regulatory alignment. As part of the broader CER, the two countries signed the Trans-Tasman Mutual Recognition Arrangement (TTMRA) in 1996.

significantly change the funds landscape in Hong Kong and the region as a whole. A mutual recognition agreement could, for example, help to unlock the substantial savings held in mainland China and would also facilitate further foreign investment in China. Moreover, if Hong Kong were the only economy to negotiate a special access agreement for sales of mutual funds to China, it would have a distinct advantage over other financial centers in the region.

In light of all the enthusiasm for mutual recognition in Asia, the mutual recognition agreement that was signed between the US and Australia in 2008 appears out of place. This quite comprehensive and very ambitious agreement would have provided a framework for the SEC, the Australian government, and ASIC to consider regulatory exemptions that would have permitted U.S. and eligible Australian stock exchanges and broker-dealers to operate in both jurisdictions without the need for those entities to be separately regulated in both countries.¹¹ The agreement was premised on two MOUs between ASIC and the SEC mandating enhanced supervisory and enforcement cooperation.¹²

Despite all of the time and considerable effort that had been spent negotiating the mutual recognition agreement between Australia and the US, it was abandoned shortly after it was signed. Undoubtedly this was due at least in part to the demands placed on the outgoing Bush and the new Obama administrations by the eruption of the global financial crisis, which forced the US government to devote considerable resources to rescue many of the country's major financial firms. The failure to follow through on the agreement may have also been due to the fact that it was extremely ambitious, particularly when compared with the more limited bilateral approaches taken in Asia. Finally, the agreement may also have been abandoned because there was no overarching political commitment in the US to deepening economic integration with Australia, despite that country's strategic location and its highly regarded regulatory system.

¹¹ These exemptions would have allowed U.S. stock exchanges and broker-dealers regulated by the SEC, subject to conditions imposed by the Australian authorities, to offer their services to Australian wholesale investors and financial firms without being subject to most ASIC regulation. Likewise, eligible Australian stock exchanges and broker-dealers regulated by ASIC, subject to conditions imposed by the SEC, would have been able to offer their services to certain types of U.S. investors and firms without being subject to most SEC regulation.

¹² See "Memorandum of Understanding Concerning Consultation, Cooperation and the Exchange of Information Related to Market Oversight and the Supervision of Financial Services Firms between the SEC and ASIC" and "Memorandum of Understanding Concerning Consultation, Cooperation and the Exchange of Information Related to the Enforcement of Securities Laws between the SEC and ASIC", both dated 25 August 2008. For an extended discussion of the Australia-US mutual recognition agreement see Pierre-Hugues Verdier (2011), "Mutual Recognition in International Finance", *Harvard International Law Journal*, Vol. 52, Number 1, pgs. 55-108.

B. IOSCO's Possible Agenda on Mutual Recognition

Given the importance of this issue and IOSCO's position as both the primary standard setter and global forum for securities regulators, IOSCO's Task Force on Cross Border Regulation can play a major role in promoting mutual recognition among securities market regulators. We understand that IOSCO's Task Force on Cross Border Regulation will be involved first in scoping work examining the continuum of mutual recognition including passporting and substituted compliance in order to determine how these different concepts are defined and work in different jurisdictions. As part of its larger work, we suggest that there are a number of issues that the Task Force could also examine, including:

1. Providing empirical evidence about mutual recognition agreements

As was shown earlier in this paper, there are a number of mutual recognition agreements already in place in Asia as well as the agreement between Australia and the US that was negotiated although not implemented. Indeed, there may be more mutual recognition agreements in existence than were examined here. Therefore, it would be extremely useful if IOSCO could provide a detailed empirical analysis with detailed information about these agreements. This could include information about the types of additional agreements or MOUs that were needed in order to bring mutual recognition into existence. For example, the Australia-US mutual recognition agreement included two MOUs regarding supervision and enforcement which were seen as necessary in order for the larger mutual recognition agreement to be reached. It would be useful to know if similar MOUs were required in any of the mutual recognition agreements currently in existence in Asia. It would also be useful to have detailed information about what the mutual recognition agreements actually cover and, if possible, the impact that the agreements have had on capital flows between the signatory jurisdictions.

In addition, it would also be useful to know the details of the comparability analyses that have been carried out so that different mutual recognition agreements could be reached. For example, reportedly the mutual recognition agreement between Australia and the US did not require line by line equivalence between Australian and US regulations, but instead relied on an analysis of the core securities regulatory principles in each jurisdiction and the manner in which those

principles were implemented.¹³ It would be useful to have more information about the high level analysis that was carried out for the Australian-US mutual recognition agreement. It would also be useful to know what type of comparability analyses were carried out for the mutual recognition agreements in place in Asia.

It would also be extremely useful if the Task Force could delineate clearly in its work the specific sectors within the securities market where mutual recognition has been the most “successful”. For example, the review of mutual recognition efforts in Asia provides a number of examples of sector specific mutual recognition agreements. These include mutual recognition for: (1) cross-border funds management; (2) cross-border capital raising; and (3) the training and accreditation of market professionals. The Task Force may find in its work that mutual recognition in certain specific sectors, such as cross-border funds management for “professional” or sophisticated investors, would be far easier to achieve than a mutual recognition agreement that covered a broader range of financial services and investors.

Alternatively, it may be useful for IOSCO to initially focus mutual recognition efforts on those markets or products or areas of regulation where regulations in some jurisdictions either have an extraterritorial impact and/or conflict in important ways with regulations in other jurisdictions. For example, IOSCO could help to foster a global substituted compliance or mutual recognition agreement for the OTC derivatives market. Such an agreement would be important since there are still substantial differences in the regulations that different jurisdictions have developed for the OTC derivatives market, which in turn could have negative consequences for the global OTC derivatives market. Such an agreement could begin with a substituted compliance or mutual recognition agreement for the OTC derivatives market between two important jurisdictions, which then could be joined by other jurisdictions.

Finally, based on the empirical analysis of the agreements that have been reached to date and those that are in the planning stages, it may be useful for the Task Force to develop a “model” or prototype for how a mutual recognition agreement could be structured. This could include sector specific mutual recognition agreements as well as much broader types of mutual recognition agreements, such as the 2008 agreement between Australia and the U.S.

¹³ See Verdier, *op. cit.*

2. Developing high-level principles for mutual recognition

Based at least in part on the empirical information that it gathers on the mutual recognition agreements already negotiated, whether functional or not, IOSCO could develop high-level principles for mutual recognition between securities regulators. This could include high level principles setting out the conditions necessary in order for a mutual recognition agreement to be reached, including most critically principles for the assessment of “comparability” between regulatory regimes. We suggest, for example, that any comparability assessment should be principles-based and focused on whether the regulatory objectives, intended outcomes and supervisory resources and practices in individual jurisdictions are similar enough to one another, rather than insisting on identical regulation as a prerequisite to mutual recognition. In addition, comparability assessments would need to focus on the regulatory regime as a whole, rather than looking at individual regulations.

If the empirical evidence shows that mutual recognition agreements require enhanced cross-border supervision and enforcement cooperation, beyond what it provided in existing instruments such as IOSCO’s MMOU, any principles for mutual recognition agreements would also need to include a framework setting out at a high level how information exchange, and supervisory and enforcement actions could work in mutual recognition agreements. In that area, IOSCO could draw upon its 2010 report on *Principles Regarding Cross-Border Supervisory Cooperation* along with other relevant reports by IOSCO and its members in order to develop principles regarding how the separate agreement, for enhanced supervision and enforcement cooperation, could be structured.

3. Developing a methodology for comparability assessments

In addition to developing principles for mutual recognition, it is critical to have a globally agreed upon process for achieving mutual recognition. A first step toward that goal would be for IOSCO to develop a methodology that would allow regulators to compare the extent to which different regulatory systems produce similar outcomes. A more sophisticated and efficient method for comparing national regulatory systems would make "comparability" assessments, which form the basis for mutual recognition agreements, more reliable and would therefore help

to widen the appeal of mutual recognition as a viable option. An improved assessment methodology would be particularly useful in developing mutual recognition agreements between jurisdictions with different legal systems and regulatory philosophies. Here again, it is quite likely that IOSCO could draw upon its other work streams, including in particular the work being done by IOSCO's newly created Assessment Committee.

4. Training regulators to encourage consistency in comparability assessments

IOSCO might also play a role by training regulators on how to carry out compatibility assessments of one another's regulatory regimes. This is critical since, at the end of the day, mutual recognition is only possible when the regulators that would be party to the agreement are fully satisfied that the regulatory and supervisory standards and practices in the other jurisdiction(s) are sufficiently similar to their own that they can, in effect, outsource some portion of their regulatory responsibilities. The process of learning deeply about another regulator's standards and practices can result in a positive feedback loop, as each regulator can potentially see areas where their own standards and practices can be improved. This learning process could extend to shaping common approaches to regulatory challenges. In this manner, over time mutual recognition could serve as a bridge to a closer convergence of regulatory standards and practices, all of which is entirely consistent with IOSCO's mission to "... exchange information at both global and regional levels...in order to assist the development of markets, strengthen market infrastructure and implement appropriate regulation".

Alternatively, a global body could be established that would be entrusted with the task of carrying out comparability assessments or an already established global body could take on that work. IOSCO could be the appropriate global entity to carry out comparability assessments as a prelude to mutual recognition agreements between securities regulators. Such an approach would have the advantage of maintaining consistency in terms of how comparability assessments were carried out and the methodology used for those assessments.

5. Targeted capacity building among regulators

One of IOSCO's main missions is to build capacity among its members, particularly those from emerging market economies. We suggest that it could target its capacity building efforts in order

to further encourage mutual recognition among a broad range of securities market regulators. This is important since it is assumed that mutual recognition is only carried out between regulatory agencies with similar levels of sophistication and similar approaches. Therefore, in order to increase the opportunities for mutual recognition, it would be useful for IOSCO to work with regulators in order to upgrade their knowledge and understanding in areas that would be most beneficial for encouraging mutual recognition with other regulators.

6. Developing additional standards to support mutual recognition

IOSCO clearly devotes a great deal of its resources toward developing high level global standards for securities markets. In some cases, these standards have already played a role in facilitating mutual recognition. This is the case in the ASEAN economies, for example, since as discussed earlier in this note securities market regulators in Singapore, Malaysia and Thailand have recently agreed to implement the ASEAN Disclosure Standards Scheme for cross-border offerings of equity and plain debt securities. These disclosure standards are based on the standards for cross-border offerings that were developed several years ago by IOSCO. Based on the empirical evidence that it gathers from the experience in Asia and other regions with mutual recognition between securities market regulators, it is quite likely that IOSCO could develop other types of global standards that would help to facilitate mutual recognition among securities regulators.¹⁴

¹⁴ As Nicolaidis and Shaffer write, “International standards can facilitate the negotiation of bilateral mutual recognition agreements because, when parties operate under common standards and procedures, they more easily understand and develop trust in each other’s regulatory practices to enforce these standards.” See Kalypso Nicolaidis and Gregory Shaffer (2005), “Transnational Mutual Recognition Regimes: Governance without Global Government”, *Law and Contemporary Problems*, Vol. 68, No. 3-4, page 273.