Substituted Compliance: The Emergence, Challenges, and Evolution of a New Regulatory Paradigm

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ABSTRACT

Over the past few decades, the US Securities and Exchange Commission experimented with a number of different approaches to relaxing Securities and Exchange Commission (SEC) rules to facilitate entry of foreign firms into US capital markets. Initially, the SEC favoured an approach I denominate as modified national treatment, under which foreign firms were allowed exemption from a limited number of specific US requirements that were likely to conflict with, or be redundant with respect to, regulatory requirements in their home jurisdictions. In general, these exemptions were available regardless of the quality of home country oversight. Sometimes those exemptions were available only for transactions with large institutional investors located in the USA. Starting in 2007, the Commission began to contemplate more far-reaching acceptance of foreign regulatory oversight, most prominently in an approach that came to be known as substituted compliance. A hallmark of substituted compliance was that it was to be selective, and thus available only to those jurisdictions that the Commission determined to be substantially comparable to US regulatory oversight. In the face of the Global Financial Crisis in 2008, the Commission backed away from its initial experiment with substituted compliance, but the exercise still offers an interesting content in which to consider the manner in which the Commission might have determined the comparability of foreign regulatory systems. This essay explores the various analytical options available for making such supervisory assessments. It then concludes with some preliminary thoughts on what might be called ‘second-generation’ substituted compliance, which the SEC and the Commodity Futures Trading Commission have begun to employ in the past few years to limit the extraterritorial application of certain provisions of the Dodd–Frank Act.

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Hardly a day passes without the emergence of some new evidence of the inter-connectedness of the world’s financial markets. In Global Financial Crisis of 2008, mounting losses on sub-prime mortgages made in the USA passed immediately onto the European and Asian balance sheets and posed vexing questions for regulatory policy for financial supervisors across the globe. A few years later, weaknesses in Greek debt markets transmit through the European financial sector with instantaneous repercussions in North America and beyond. Implementation of the numerous provisions of the Dodd–Frank Act of 2010 and post-financial crisis reform in many other jurisdictions raised thorny questions of extraterritorial application. Any serious discussions of domestic financial reforms in major markets must now be debated with an eye towards international competitiveness for it is now widely recognized that both capital and financial services firms are highly mobile, and relatively small differences in regulatory requirements can cause financial business to move to more friendly markets. And the inter-connectedness of global financial markets means that the quality of financial supervision in all major financial centres has implications around the globe.

Against this market reality, the problem of regulatory coordination across national boundaries has become increasingly important. Whereas national authorities might traditionally have imposed local systems of oversight on all financial transactions and firms that do business within the territory of the state, increasingly this territorial approach has proven to be redundant, costly, and ultimately ineffective. While the limitations of old territorial approaches are apparent, it is less clear how financial regulators should alter their supervision of cross-border transactions and global firms in the 21st Century. As the Global Financial Crisis of the last decade demonstrated, inadequately supervised financial transactions in one jurisdiction can impose private and public costs elsewhere, costs well beyond direct losses incurred by investors who made poor investment choices. Local interests in the quality of supervision of cross-border transactions and financial firms operating on a global basis are, therefore, genuine, and a purely laissez-affaire attitude is unlikely to be desirable or sustainable in the long run.

As students of private international law will recognize, the problem I am discussing is fundamentally a choice-of-law question. Which nation’s regulatory system (or combination of national regulatory systems) should govern cross-border transactions or apply to financial firms doing business on a cross-border basis? Unlike traditional choice-of-law questions, however, jurisdictional decisions in the financial arena are not usually supplied by a presiding judge applying conflicts-of-law principles. Nor are these matters routinely resolved through choice of law provisions in private contracts. Rather, the allocation of regulatory jurisdiction is ordinarily determined prospectively through some combination of statutory provisions and administratively promulgated regulations. Sometimes the rules are decided unilaterally, other times through treaty negotiations or less formal memoranda of understanding among administrative units.

What I propose to discuss in this essay is how American financial regulators, particularly those at the Securities and Exchange Commission (‘SEC’ or ‘Commission’) approached the extraterritorial application of US financial regulation in the years just before the Global Financial Crisis. My emphasis here will be on the Commission’s
efforts to accept certain foreign regulatory regimes as an acceptable form of ‘substituted compliance’ for certain foreign financial firms doing business in the USA, what I will later denominate as ‘in-bound’ first-generation, substituted compliance to contrast it from ‘out-bound’ second-generation substituted compliance that has more commonly characterized post-financial crisis applications of ‘substituted compliance’. While the SEC’s experiments in in-bound substituted compliance were largely shelved with the onslaught of the Global Financial Crisis in 2008, the SEC’s early work on the topic and similarly spirited companion initiatives of the same era offer valuable lessons for this general approach to cross-border coordination. Determining which foreign regulatory regimes provide reasonable substitutes for domestic regulation poses both analytical and political challenges. The capacity of regulatory officials to make objective assessments of comparability likely differs across regulatory context, being more tractable in some areas (like assessing capital market efficiency and trade execution) and perhaps less tractable in others (such as certain kinds of consumer protection or the mitigation of systemic risks).

While the discussion that follows focuses primarily on the years leading up to the Global Financial Crisis, the analysis offers a potentially useful backdrop for exploring more recent efforts of the SEC and other federal financial regulators to develop a second-generation, out-bound of substituted compliance regimes to accommodate the application of various provisions of the Dodd–Frank Act to extraterritorial transactions and firms. These developments are treated in some depth in a companion essay by Alexey Artamonov, to which I will refer towards the end of this essay. While the contexts in which out-bound substituted compliance is being applied differ from the context of the approach’s original application, the challenges of application remain similar and there may well be lessons for today’s policy makers from the SEC’s experiments of a decade ago.

THE RISE AND IMPENDING FALL OF THE SEC MODIFIED NATIONAL TREATMENT

The need for trans-Atlantic financial regulatory cooperation has been apparent for several decades. Back in 1974, the closure of the Herstatt Bank in Cologne sent shock-waves through New York as numerous US counter-parties found themselves facing losses on unsettled foreign exchange transactions. That crisis gave rise to a new term in financial regulation—‘Herstatt risk’—and also led to the creation of the Basel Committee on Banking Supervision and the adoption of the so-called Basel Concordat, which established a new principle of international banking supervision that the home country supervisory—Germany in the case of Herstatt Bank—would have responsibility for overseeing offshore branches, such as ones in New York. And, as a corollary, regulators in a host country, such as the USA, started to routinely demand that new foreign banks demonstrate that there exists effective and

comprehensive oversight in their home jurisdictions. While the application of this standard has often been tested over the years—with the failure of Bank of Credit and Commerce International (BCCI) being a particularly notorious example—the notion that qualified home country oversight should be a pre-requisite for the establishment of cross-border banking offices has long been accepted in the field of banking.

In the area of capital market oversight, in contrast, the principle that the quality of home country oversight should factor into host country regulatory standards was slower to develop and is still less well recognized. In part, banking regulators led the way in cross-border coordination because the banking market became global ahead of capital markets and also because the Bank of International Settlements in Basel provided a ready and well-respected vehicle for coordinating international banking policy. Public capital markets, in contrast, were largely national affairs several decades ago, and relatively undeveloped in many jurisdictions—particularly continental European jurisdictions—in the post-War period. But, by the 1980s, the volume of cross-border securities offerings and multiple listing were on the rise, and since the early 1990s, much attention turned on the appropriate regulation of cross-border linkages involving capital markets, especially capital markets located in the USA.

Rather than a foreign bank with a cross-border branch, the characteristic cross-border capital market transaction of that era was a stock offering from a large European corporation—that was listed on the New York Stock Exchange (NYSE) as well as on the London Exchange (Figure 1). The traditional American approach was to impose something close to national standards on foreign firms seeking access to US markets, without regard to whether the applicant company was already regulated in a well-regarded market such as London or based on one of those sketchier island locations, better known for memorable scuba-diving than good financial supervision. But as the volume of these cross-border capital raising transactions increased in the 1990s, US authorities moved away from a mechanical application of domestic rules to a regime that might better be denominated modified national treatment.

The SEC had long recognized that foreign firms cannot be treated in exactly the same manner as domestic firms, and over the years has gone to considerable lengths to articulate bright-line rules that clearly define when foreign issuers will be subject to US regulation. So, for example, starting in the 1960s, most American firms with more than 500 shareholders and assets above a minimal threshold had to comply with SEC periodic reporting requirements under the Securities Exchange Act of 1934. But for foreign firms, the reporting rules generally applied only if the firm’s securities are listed for trading on a major US market—a well-defined action that foreign firms could usually avoid without difficulty. Moreover, since the 1990s as a result of another SEC regulation (rule 144A) foreign issuers have even been able to...

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3 A prominent counterexample has been the European Union’s internal market, which has a well-developed system of host country deference to home country oversight, within the highly structured framework of EU directives and Lamfalussy implementation and coordination. The new paradigm which I discuss in this essay differs from the EU approach because it does not take place within a well-developed treaty system such as the EU, but rather exists between regulatory systems that are linked by nothing more than memo-randa of understanding between regulatory official and shared experiences in coordinating organizations such as IOSCO or the FSB.

4 See 17 CFR s 240.12g3-2.
raise capital in the USA without complying with SEC reporting requirements as long as they limited their offerings in the USA to large institutional investors and structured their sales of securities outside of the USA to comport with a provision known as Regulation S. As a result of these bright-line rules, foreign issuers could maintain a relatively high degree of interactions with US investors in the USA without being subject to the SEC extensive reporting and accounting requirements.

The second component of US modified national treatment was a host of pragmatic accommodations for those foreign firms that did choose to subject themselves to SEC reporting and registration requirement. Roughly speaking, the SEC exempted foreign issuers from those aspects of our securities laws addressing issues of corporate governance, where US standards were likely to conflict with applicable requirements of the issuer’s home country regulations. Examples of these exemptions include the proxy rules, mechanical restrictions on inside trading under section 16 of the Securities Exchange Act of 1934, as amended, certain disclosure requirements (such as those requiring specific details of executive compensation), and also the application of many specialized rules governing tender offers and mergers. As was well

5 See 17 CFR s 230.901-905. For technical reasons known as the non-fungibility requirement, US public firms are generally not permitted to raise equity through 144A offerings, but may only use the exemption for debt issuances. See 17 CFR s 230.144A(d)(3)(1).

6 See SEC Concept Release on Multinational Tender and Exchange Offers, 55 Federal Register 23,751 (6 June 1990). The application of these rules to foreign issuers has remained a continuing source of complexity and the Commission updated them with yet another set of accommodations in this area in 2008. See SEC Final Rule on Guidance and Revisions to the Cross-Border Tender Offer, Exchange Offer, and
chronicled at the time, the Commission faced considerable complexity in determining just what accommodations of this sort were appropriate, with the Sarbanes-Oxley Act of 2002 representing what was widely regarded—on both sides of the Atlantic—as a deviation from past practices as the Act, at least initially, imposed a number of corporate governance standards on foreign issuers, often conflicting with local practices such as the composition of supervisory boards in Germany and other jurisdictions. While the most egregious of the conflicts were eventually smoothed over, the Sarbanes-Oxley Act experience awoke foreign firms to the perils of exposing themselves to overlapping securities oversight and prompted pressures (to which the SEC eventually succumbed) to make it easier for foreign issuers to exit US reporting requirements, a decision which is itself another example of modified national treatment, as the rules governing foreign delistings became (in important respects) more liberal than those applicable to US domestic firms.

Aside from the shock of the disturbance of Sarbanes-Oxley, a number of other factors put increasing pressure on America’s traditional treatment of foreign firms at the turn of the Millennium. A few were legal, but most were economic. On the legal side were US anti-fraud rules, as enforced through our peculiarly idiosyncratic and draconian system of class action securities litigation. The SEC’s approach to accommodation of foreign issuers was limited to regulatory requirements—registration and reporting rules. Thus, the US courts, not the SEC, determined the scope of jurisdiction to hear securities cases, and there were now few clear rules defining when foreign issuers may be drawn into US courts. While the actual incidence of successful cases involving securities law claims was relatively infrequent before 2000, a number of prominent cases were brought against foreign issuers in the early 2000s. And, for many foreign issuers, the potential threat of litigation more than offset the accommodations that the SEC offered on more mechanical aspects of compliance. While the Supreme Court’s 2010 decision in *Morrison v Australia National Bank* substantially reduced the threat of US class action suited against foreign issuers not listed on US stock exchanges, the threat of US legal liability did represent a serious concern for foreign issuers in the years before Morrison was decided, and the issue remained relevant, even after 2010, for foreign issuers contemplating US listings or over-the-counter transactions deemed to take place in the USA.

Another, perhaps even more important fact was the new found mobility of investors (as well as issuers). The traditional SEC approach tied US regulatory jurisdiction to foreign activities that reached into American territories, with the characteristic transaction being the sale of foreign stock to US-based investors. But, this conceptualization presupposed that American investors were trapped in the USA. In reality,

Business Combination Rules and Beneficial Ownership Reporting Rules for Certain Foreign Institutions, 73 Federal Register 60,050 (9 October 2008).

7 See SEC Final Rule on Termination of a Foreign Private Issuer’s Registration of a Class of Securities, 72 Federal Register 16,934 (5 April 2007).


however, investors were mobile too. For a host of reasons—some regulatory and some operational—American institutional investors in the 1990s began locating operations outside of the USA and nearer to foreign financial centres, such as London, Tokyo, and Hong Kong.\footnote{Howell E Jackson and Eric Pan, ‘Regulatory Competition in International Securities Markets: Evidence from Europe – Part II’ (2008) 3 Virginia Law & Business Review 207. See also Erica Fung, ‘Regulatory Competition in International Capital Markets: Evidence from China in 2004-2005’ (2006) 3 NYU Journal of Law & Business 243.} So too, retail investor began following a similar path, finding that they could direct order through foreign intermediaries to purchase foreign securities directly on foreign markets rather than just limiting themselves to foreign securities dual listed on American exchanges.\footnote{Howell E Jackson, Mark Gurevich and Andreas M Fleckner, ‘The Controversy Over the Placement of Remote Trading Screens from Foreign Exchanges in the United States’ (2006) 1 Capital Markets Law Journal 54.}

To some degree, the SEC’s modified territorial approach to foreign capital market activities facilitated its own erosion. As mentioned above, to accommodate an increasingly global world in the 1980s and 1990s, the SEC established those bright-line, highly administrable standards for determining when foreign issuers were located in the USA. These precise rules provided clear-cut guideposts for avoiding US jurisdiction and thus allowed practitioners to devise strategies for foreign firms to reach an increasingly large share of US investors without becoming formally subject to SEC registration and reporting requirements. Thus, the economic incentives for foreign issuers to seek ‘official’ access to US capital markets declined over time. At the same time, the traditional practice of the SEC to offer partial accommodations to foreign issuers that were subject to SEC jurisdiction proved to be an unreliable and imprecise form of relief, as both the vagaries as to the scope of US liability rules prior to the Morrison decision and the perhaps epiphenomenal lessons of Sarbanes-Oxley Act left foreign issuers with a high degree of nervousness in remaining subject to ongoing SEC jurisdiction, hence the flight of delistings from the NYSE in the latter half of 2007, when the Commission’s new rules on deregistration went into effect.\footnote{See Committee on Capital Markets Regulation, The Competitive Position of the US Public Equity Market 21-23 (4 December 2007) <http://capmktsreg.org/app/uploads/2014/12/The_Competitive_Position_of_the_US_Public_Equity_Market.pdf> accessed 12 October 2015.}

A full account of the transformation of this pre-financial crisis era must also include at least a nod to the declining relative importance of US capital markets.\footnote{See Luigi Zingales, ‘Is the U.S. Capital Market Losing its Competitive Edge?’ (November 2007) (ECGI Finance Working Paper No 192/2007) <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1028701> accessed 12 October 2015.} Not only was it less essential for foreign issuers to access US capital markets (because of the migration of American investors for foreign markets), but the relative importance of US capital markets had also declined with the growth of major financial centres in both Europe and Asia in the late 1990s and early 2000s. A number of considerations have contributed to this phenomenon. In many countries, there was increased reliance on capital markets as compared to bank financing. The early successes of the Eurozone, coupled with a preference for some major new sources of capital (e.g. Mideastern and Russian) for market venues outside of the USA, also contributed to the vibrancy of European capital markets. Finally, the explosion of wealth in Asia,
especially when measured against the late 1990s when many Asian markets were suppressed from their own recent financial crisis, was a further contributing factor.

There has also been a demonstrable shift in the relative quality of financial market oversight in the USA. Before the mid-1990s, the SEC and other US regulators could plausibly claim to provide the world’s premiere system of financial oversight, but the case for US primacy became less clear over time. This was not so much a product of the decline in US supervision—although some in the USA would argue that our supervision had become too costly (while others would assert that it had become too lax). But an even more important factor, at least in my view, was the enhancement of financial market supervision in other jurisdictions around the world both in terms of developing consistent and comprehensive legal requirements (often modelled on USA, ISOCO, or EU templates) and also improvements in both the quality and quantity of supervisory staffing in many countries. At the same time, the professional expertise supporting the financial services industry, once largely concentrated in New York, became better distributed around the world in the 1990s, with leading investment banks, law firms, and accounting firms operating in all major markets. So, the relative quality of US capital markets has almost certainly declined with respect to other leading markets around the world, providing yet another explanation of the decreasing power of US capital markets.

Finally, there were important changes in the political economy of policy debates within the USA in the early 2000s. The declining importance of New York, especially in the immediate aftermath of the 9/11 attacks, had implications for employment and financial well-being in an important region of the country, and fed into concerns about national competitiveness, previously limited to the manufacturing and back office service sectors. While other financial centres have long been self-conscious in their efforts to attract and retain international business, the USA had until recently taken its post-World War II financial leadership for granted. But this was no longer the case in the early 2000s, Hence the prominent role of New York politicians, such as then New York Mayor Bloomberg and NY Senator Charles Schumer, in pushing for regulatory reforms.

But there were also more subtle changes in US political considerations. One was the increasingly global perspectives of US financial institutions, who were finding themselves disadvantaged by US regulatory requirements that inhibited their ability to coordinate offshore and US operations. A prime case in point was the merger of the NYSE and Euronext in 2007. Whereas the old NYSE traditionally had resisted SEC reforms that will have facilitated the direct sale of foreign securities to US investors (without first obtaining a listing on the NYSE), the new integrated firm was more cognizant of the constraints that US regulation impose on the operations and opportunities of Euronext.

A further important influence was the perspective of US financial firms seeking to expand their operations in many developing markets around the world, in Asia, Latin America, and elsewhere. By operating in multiple, national markets, these firms found themselves subject to an increasing number of disparate regulatory structures, many modelled in general terms on SEC standards but often including distinctive and costly local variations. While US financial firms had traditionally benefitted from the somewhat protectionist aspects of the SEC’s modified national treatment in
fending off foreign competition in the USA, jurisdictional rules of this sort cut in the opposite direction for US firms seeking to expand overseas. Accordingly, to the extent that the movement of the SEC away from its modified national treatment could be tied to a world-wide trend towards a broader acceptance of home country oversight, the potential US domestic constituencies favouring such a reform increased considerably.14

TWO COMPETING APPROACH TO THE REGULATION OF CROSS-BORDER FINANCE

With the SEC’s traditional approach to extraterritorial jurisdiction under increasing pressure, the Commission on the eve of the Global Financial Crisis stood poised on the edge of a paradigm shift in our approach to cross border financial regulation. Those years witnessed two glimpses of what might have emerged as a new US paradigm to extraterritorial jurisdiction in the financial field, a regime known as selective substituted compliance. Much of the balance of this essay focuses on the structure the SEC’s then new approach to extraterritorial jurisdiction and the principal problems that the Commission would have faced in its implementation.15 But at the outset it is important to note that the old paradigm—modified national treatment—remained very much alive at the SEC, and another related initiative contemplated at the time is best characterized as a rejuvenation of that older approach.

Selective substituted compliance

The first example of the SEC’s new approach to extraterritorial jurisdiction came in 2008 with the SEC’s decision to allow foreign issuers to prepare their financial statements in accordance with appropriately implemented International Financial Reporting Standards (or IFRS).16 At first blush, this reform might look like another example of an exemptive accommodation of foreign issuers, like the relief foreign issuers have traditionally enjoyed from the SEC corporate governance rules. But there were several important differences. First, the SEC was not offering foreign issuers a blanket exemption from US accounting standards. Rather it was an exemption for only those foreign issuers that comply with IFRS, not whatever other form of accounting rules that might apply in their home jurisdiction. Moreover, not even all applications of IFRS were eligible for this relief, only versions of IFRS that have been


15 The regulatory steps summarized here are chronicled in greater detail and very helpfully conceptualized in Pierre-Hugues Verdier, ‘Mutual Recognition in International Finance’ (2011) 52 Harvard International L J 55.

appropriately implemented in the eyes of the SEC. In other words, this new reform
taunted an element of subjective evaluation over the quality of IFRS implementation.
So, in a break from tradition, the SEC put itself in the business of opining on the
quality of accounting standards around the world.\footnote{There were two other important examples of the SEC engaging in such subjective evaluations of the quality of other jurisdictions in the past. The first was the MJSD system with Canada whereby Canadian issuers since the 1990s have been allowed to access US capital markets under special exemptive relief that recognizes the comparability of US and Canadian securities regulation. Second, under Regulation S adopted in the early 1990s, the Commission granted special privileges to securities traded on certain designated exchanges, but applied the standard in a liberal manner, including all of the world’s leading markets and many minor ones. See 17 CFR ss 230.901-905.}

The SEC’s acceptance of IFRS for foreign issuers was such a striking departure of past practices that it is worth considering the factors that lead to the Commission to
take this step. One consideration was no doubt pragmatic; the previously required
reconciliation of foreign accounting standards to Generally Accepted Accounting Principles in the United States (US GAAP) had long been a source of aggravation for foreign issuers, imposing costly and time-consuming computations with only
marginal value to investors. But more important than long-standing complaints was
multi-year efforts on the part of US and international accounting standard setters to
more closely align their substantive rules. While US GAAP and IFRS were still a
long way from being harmonized, the relative quality of the two systems are generally
agreed to be much closer than they have been in the past, and there are now plausible arguments for the relatively superiority of either approach. Here was an instance
where narrowing of qualitative differences in regulatory standards allowed the
Commission to accept foreign legal requirements as an acceptable substitute for
home country (that is, USA) requirements, the characteristic feature of the new
paradigm.

Political and market factors no doubt also played into the decision. By relaxing
the accounting standards applicable to foreign issuers, the Commission clearly hoped to
dissuade some foreign issuers from exiting US public markets and similarly to en-
tice new entrants to enter notwithstanding the trauma of Sarbanes-Oxley and per-
ceived risks of US litigation. Also, the EU wielded a regulatory stick that would have been unusual in earlier years. European exchanges have long allowed dual-listed US
firms to prepare financial statements in accordance with US GAAP, a reasonable
practice as long as US accounting standards were considered the world’s gold stan-
dard. But with the rise of IFRS and the patent shortcomings of US GAAP during the
Enron/Worldcom era of accounting scandals, senior European officials quite explicitly signalled that reconciliation to IFRS might be required if US authorities did not see their way to accepting IFRS for foreign issuers. So, while the SEC decision to
accept IFRS was plausible as a matter of public policy, it also reflects an element of
realpolitik.

The second example of the new paradigm concerns a long-simmering dispute
over the placement of remote trading screens for foreign exchanges within US territ-
ory\footnote{For background on this dispute, see Jackson, Gurevich and Fleckner (n 11).} (see Figure 2). This was an issue with a strong German heritage, as the
Deutsche Börse has been one of the most active foreign exchanges seeking exemptive
authority to enter the USA without subjecting itself to full SEC registration and oversight. The SEC was, however, resistant to the idea. In contrast to its accommodating modified national treatment with respect to foreign issuers, the Commission has been relatively inflexible in dealing with foreign exchanges and (though to a somewhat lesser degree) to foreign brokerage firms. Generally speaking, access to US markets subjected the foreign exchange to full regulation under US laws, including both substantive and issuer disclosure rules that made it all but impossible to operate simultaneously in the USA, except through the creation of wholly separate subsidiaries dedicated exclusively to US activities. While justified in the USA as essential for the protection of investors, Europeans widely interpreted this approach as a protectionist requirement designed to protect the NYSE franchise.

In January 2007, the first signs that the Commission might soften its views on cross-border transactions emerged. In an academic paper written by senior SEC officials, Ethiopis Tafara and Robert Peterson, the possibility was raised that perhaps the Commission should allow foreign exchanges and securities firms to enter the USA without having to comply with US registration and reporting requirements. Provided these entities came from jurisdictions that could offer acceptable forms of ‘substituted compliance’ and themselves had good reputations, the Commission could offer fairly broadly devised exemptive relief. As with the Commission’s IFRS initiative, this approach required a subjective evaluation of the quality of supervisory oversight in individualized jurisdictions. And unlike the Commission’s traditional

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modified national treatment, the accommodations afforded foreign firms were not limited to areas of specific conflict with US requirement, rather the approach contemplated wholesale acceptance of home country supervision.

The Tafara–Peterson article constituted the most complete articulation of the justifications for moving towards a new approach to jurisdiction. In addition to familiar considerations emanating from concerns over the declining competitiveness of US capital markets, the Tafara–Peterson article emphasized the potential benefits that the new approach would offer USA retail investors. Traditionally, the SEC has cited the needs of retail investor protection as a principal reason for forcing foreign firms to comply with most US regulatory standards a precondition to accessing US capital markets. But Tafara and Peterson countered that these requirements may actually impede the ability of retail investors to diversify internationally in a cost-effective manner. At least with respect to transactions originating from other well-regulated financial markets, Tafara and Peterson argued, retail investors might well benefit from a more relaxed approach to SEC oversight. Thus, they reasoned, once the SEC determined that foreign regulation was an acceptable substitute for US requirements, a more hands off approach to certain cross-border transactions might well be in the public interest.20

In the months following its publication, the Tafara–Peterson framework was much discussed—being the subject of an online academic symposium at Harvard and a roundtable discussion at the SEC in the following year.21 In the Spring of 2008, the Commission itself announced that it intended to move forward with a pilot project on mutual recognition involving Australia22 and two months later announced that it planned to conduct a similar experiment with Canada.23 While the Canadian initiative quickly fizzled, apparently as a result of difficulties dealing with the provincial system of securities oversight in Canada, the Australian effort did get to the framework agreement phase; however, no actual exemptive relief was ever granted either for an exchange or for a foreign securities firm.24 As the implementation of this new system of selective substituted compliance raised several challenging questions of regulatory policy, I will in ‘Measuring the Quality of Regulatory Oversight in Foreign Jurisdictions’ section of this essay consider in some detail the issues that the Commission would have faced in determining which jurisdictions should be eligible for the substituted compliance determinations in addition to Australia and Canada. But before turning to those issues of implementation, I consider a second SEC initiative concerning jurisdiction over foreign firms.

24 See Verdier (n 15) 82–88.
Proposed expansion of rule 15a-6

When the Commission first announced that it was planning to move ahead with a pilot programme involving substituted compliance, it also signalled that the Division of Markets and Trading would also be undertaking a review of rule 15a-6, which exempts certain foreign broker-dealers from registration under the 1934 Act. This complicated rule, first adopted in 1989, exempts from the 1934 Act registration of foreign brokers that have only a limited amount of contact with US institutional investors, and offers somewhat more lenient treatment for transactions involving US institutional investors with more than $100 million of assets under management. The regulation, which is highly technical and often requires foreign broker-dealers to obtain ‘chaperoning’ services from US registered firms, has long been the source of criticism from practitioners and the Commission has long been under pressure to liberalize the rule. In June of 2008, the Commission proposed such a change. (Again, the proposal was never adopted.) Under the Commission’s proposal, foreign broker-dealers would have much wider latitude to do business with US investor, both relaxing many of the technical requirements of the prior rule and also lowering the level of favoured institutions to those with less than $25 million under management and for the first time also granting relief for contacts with natural persons managing portfolios of similar size.

The Commission’s proposed reform of rule 15a-6 is best understood as a continuation of the Commissioner’s older modified national treatment approach; it narrowed the scope of domestic regulation for foreign firms that constrain their US activity within clearly defined boundaries and did so without consideration of the quality of supervision in the firm’s home jurisdictions. The proposal would thus have been available for broker-dealers based in any jurisdiction around the world, and not just dominant financial centres, such as London or Tokyo, where large numbers of major securities firms are based. Among Commission staff, the proposal was sometimes portrayed as being in competition with the substituted pilot programmes with Australia and Canada, and comparing the two approaches is illuminating.

A critical issue was the rule 15a-6 proposal’s treatment of retail investors. Especially among traditionalists at the Commission there was concern that the proposed rule could expose qualifying retail investors—that is, those with more than $25 million in investable assets—to unregulated and possibly also unscrupulous securities firms. While a number of SEC exemptions turn on the net worth of individual investors and often employ much lower thresholds than the new $25 million level proposed for rule 15a-6, those exemptions traditionally have involved domestic transactions that take place against an institutional setting where federal anti-fraud rules clearly apply and dispute resolution through judicial venues or arbitration is readily available. Under the SEC’s proposal, retail investors with sufficient assets would have been able to engage in largely unregulated interactions with foreign

25 17 CFR s 240.15a-6.
26 See eg, Tahyar and others (n 14).
28 See r 501(a) of Regulation D under the Securities Act of 1933 (including within the definition of accredited investor individuals with net worth of more than $1 million). See also s 2(a)(51) of the
brokerage houses, even those located in unsavory jurisdictions or without good reputations in their home markets. By eliminating any element of SEC pre-approval, the proposed 15a-6 reform relied almost exclusively on principles of caveat emptor, requiring simply that US investors be informed that domestic regulatory safeguards do not apply.

Another criticism of proposed rule 15a-6 reforms concerned those retail investors that are excluded from its coverage. Under the proposal, foreign broker-dealers would be denied exemptive relief if they did business with natural persons managing portfolios of less than $25 million. Accordingly, the proposal would do nothing to increase the access of most retail investors to foreign brokerage firms, and indeed might have reduced access if some foreign firms were to choose to close up existing US subsidiaries and to rely instead on the SEC’s new exemption. To the extent that the Tafara–Peterson framework was motivated out of a concern to increase the international diversification of retail investors, the 15a-6 proposal could actually have been viewed as counterproductive.

A perhaps related concern about proposed rule 15a-6 concerned the loss of SEC bargaining power that the proposal entails. A somewhat counter-intuitive factor motivating the Tafara–Peterson approach of selective substituted compliance was a desire to influence the regulatory systems in other jurisdiction. While substituted compliance entails deference to home country oversight, the negotiations leading up to such arrangements afforded an opportunity for the Commission to seek various accommodations from other jurisdiction. The Tafara–Peterson framework contemplated the creation of memoranda of understanding to deal with the coordination of enforcement activities—a process already in place with most jurisdictions likely to participate in these new arrangements. But the negotiating over whether a jurisdiction should qualify for substituted compliance could give the SEC an unprecedented opportunity to influence substantive components of foreign regulatory systems. In contrast, the proposal for rule 15a-6 was based on unilateral action of the SEC and granted exemptive relief without regard to the quality of supervision in foreign jurisdictions. Not only did the proposal deny the Commission any opportunity to influence the securities market oversight of other jurisdictions, it might have reduced the Commission’s bargaining power in areas where a regime of selective substituted compliance governs, as foreign jurisdictions will have less to gain from SEC validation.

Comparing the two approaches

Taken together, the Commission’s rule 15a-6 proposal and its initiatives involving substituted compliance represented two separate visions of how to approach extraterritorial application of US financial regulation, each with its own advantages and disadvantages. The former represented an extension of modified national treatment, with a contraction of direct SEC oversight for an expanded range of transactions involving wealthy individuals and institutional investors. An advantage of this approach

Investment Company Act of 1940 (defining qualified purchasers, who are generally eligible to invest in hedge funds, to include natural persons with investments of more than $5 million).

29 As part of the Australian framework, the SEC and Australian authorities adopted a pair of additional memoranda with respect to cooperation and information sharing.
was that it could be undertaken unilaterally, without bilateral negotiations or subjective evaluation of foreign supervision. However, the approach also exacerbates what is been called the ‘deretailization’ of securities markets, an ongoing process whereby securities markets are segmented into a growing but less regulated market limited to institutional investors and wealthy individuals and a shrinking and more heavily overseen market open to all investors.30

The mutual recognition exemplified in the Tafara–Peterson framework envisioned a more fully integrated global system of capital markets, at least among countries with well-developed systems of regulatory oversight, with greater investment opportunities made available to all retail investors. It contemplated a fairly large amount of collaboration across national borders and depended upon a reasonable amount of regulatory convergence of the sort that preceded the SEC’s acceptance of IFRS as an alternative to US GAAP reconciliation. Thus, an indirect benefit of the mutual recognition approach was the dialogue it would create among national supervisors through peer-review mechanism with substantial benefits for countries whose supervisory systems are deemed to meet international standards. A potential drawback of the substituted compliance approach, to which I will turn in a moment, is the complexity of vetting foreign regulatory structures and devising mechanisms for ensuring that foreign supervision applies effectively and consistently to cross-border transactions.

Conceivably, the relative merits of the two approaches might counsel for the application of modified national treatment in some contexts but substituted compliance in another. Though beyond the scope of this essay, one might imagine that difficulties of ascertaining the quality of broker-dealer oversight and ensuring its effective application to offshore transactions might militate against the use of selective substituted compliance for foreign securities firms seeking to do business with retail investors in the USA. Conversely, the regulation of corporate issuers and even exchanges might more easily validated through objective standards and fully capable of protecting remote investors. Thus, the sale of securities issued from qualifying jurisdictions might be appropriate for substituted compliance.

Interestingly, the framework agreement that the SEC adopted with Australian officials actually would have included elements of both approaches. While the framework’s approach for allowing Australian exchanges to enter into the USA reflected a wholesale adoption of the original Tafara–Peterson proposal with full access to US retail investors, the framework’s authorization of cross-border access by Australian securities firms was to be limited to institutional investors and individuals with more than $25 million of investments.31 So, in essence, the framework offered a more


limited liberalization for foreign broker-dealers than had been contemplated in the SEC proposed amendment to rule 15a-6, as the framework’s application was premised on a comparability determination of the sort not contemplated in the rule 15a-6 proposal.

MEASURING THE QUALITY OF REGULATORY OVERSIGHT IN FOREIGN JURISDICTIONS

While the SEC’s experiment with implementation of the original Tafara–Peterson proposal for substituted compliance was never fully implemented, it remains interesting to engage in a thought experiment as to how the Commission staff might have gone determining whether Australia offered a sufficiently comparable system of securities market oversight so as to allow the Australian stock market and perhaps also Australian brokerage firms to have unrestricted access to American markets? The adoption of the framework agreement—even if not actually implemented—suggests that the Commission staff must have made such a determination, but the basis on which they reached this conclusion was never made clear.32

One possibility would be simply to rely upon the reputation of Australian authorities, based on the SEC staff’s experience of working with Australian authorities over a number of years. While a plausible approach—and undoubtedly a consideration that would play some not-inconsiderable role in any Commission’s decision-making—such an informal process would be unlikely to produce sufficient legitimacy for the acceptance of foreign regulatory systems in the USA nor would it likely to be an attractive approach when the Commission comes to jurisdictions that it was not prepared to accept as an adequate substitute for compliance with US reporting or registration requirements. What is needed is something considerably more objective.

Another possible alternative would be a review of the formal legal requirements applicable to Australian capital markets with a view towards assessing whether all the relevant regulatory bases were covered—disclosure, market manipulation, trading practices, etc. But while substantive legal standards may be a necessary condition for ascertaining the comparability of another regulatory system, legal rules alone are

SEC–Australia Mutual Recognition Framework (n 31), Item Five (Assessment of Regulatory Frameworks). While this language is clear that some sort of assessment was made, the content of the assessment is almost completely opaque, and there is a suggestion that the terms of the assessment may have borne on the actual exemptive relief granted market participants.
unlikely to be found sufficient. The formal adoption of legal requirements does not, after all, ensure their compliance. Some elements of supervision and enforcement are also needed. Thus, the SEC is likely to consider as well the level of regulatory intensity in foreign jurisdiction, and this dimension of evaluation likely was one of the reasons why the SEC chose to start its original experiment in substituted compliance with Australia. What follows is a short summary on the sort of data on regulatory intensity that would have been available to the SEC in 2008 in the months leading up to its agreement with Australian authorities, as well as potential limitations on that data that would have been apparent at the time.

**Regulatory intensity as measured through budgets and staffing**

Though a relatively small financial market—with a domestic stock market capitalization of US$1.3 trillion at the end of 2007 as compared to London’s US$3.8 trillion and Japan’s US$4.3 trillion—Australia distinguished itself in the very substantial amount of supervisory resources dedicated to policing its capital markets. Based on 2005 data reported in a contemporaneous paper that I co-authored with my colleague Mark Roe, Australia deploys just under 40 staff members to securities market oversight for every million in the country’s total population, whereas the USA and the UK dedicated closer to 20 and civil law jurisdictions such as Germany and Italy maintain in the range of 4–8 staff per million of population.33 Comparable differences emerge if one looked at regulatory budgets as a fraction of gross domestic product or stock market capitalization at the time. Australian securities officials also distinguish themselves when it comes to enforcement activity, dedicating a higher proportion of regulatory staff to enforcement activities and bringing many more enforcement actions per trillion dollars of stock market capitalization than do many other jurisdictions.34 So, quite plausibly, the SEC might have been expected to consider both the level of regulatory inputs (staffing and budgets) as well as some measures of regulatory outputs (enforcement activities and other objective measures of supervision) (see Figures 3–5). While there is a growing body of empirical evidence supporting the use of both measures in accessing the quality of a country’s supervisory apparatus,35 there are also limitations to these approaches, which could be categorized as incompleteness, misdirection, and inadequate granularity.

**Incompleteness**

No matter how one attempts to measure regulatory intensity across jurisdictions, there is always a concern that one has failed to identify all relevant regulatory inputs. This problem is most apparent for staffing and budget measures. The UK, in the pre-financial crisis era, offered a good example. While the UK’s Financial Services Authority (FSA) was perhaps the premiere example of a consolidated supervisory

Figure 3. Total financial regulatory staff per million of population.

Figure 4. Annual public securities enforcement actions per trillion dollars of market capitalization in 2004.
agency at the time, the British actually maintain several other regulatory bodies that
fulfil functions comparable to those of the US SEC. The British Financial Reporting
Council employed a staff of 55 with a budget of £14.5 million policed auditing firms
and the accounting statements of corporate issuers, and undertook activities compa-
rable to those of the SEC’s Division of Corporate Finance and the Public Company
Accounting Oversight Board (PCAOB). The Panel on Takeovers and Mergers also
played an important role, somewhat comparable to the SEC’s with respect to proxy
fights and tender offers. Regulatory comparisons that relied solely on FSA staffing or
budget levels miss these other important regulatory components.

The supervisory functions of stock exchanges also complicate comparative head
counts. In the USA, the supervisory activities of the NYSE and NASD had, for a
number of years, major supervisory units which have subsequently been moved to
the Financial Industry Regulatory Authority (FINRA). Staffing and budget levels for
government agencies do not incorporate the resources of self-regulatory organiza-
tions. Around the world, the supervisory roles of exchanges have diminished with the
demutualization of all major exchanges and the dictates of EU listing directives.36
However, regulatory functions do still take place in many exchanges, especially with
respect to the review of new listing applications, where exchange personnel often
take on roles similar to, though invariably less intensive than, those of SEC staffers
who review registration statements for IPOs. The Hong Kong stock exchange’s over-
sight of new listings would be a good example of this role.

California Law Review 1239.
Finally, there is variation in the reliance that different regulators make of private assistance. Within the German civil law tradition, this reliance seems particularly striking. Germany’s BaFin, for example, makes use of outside audits to supplement regulatory oversight. The Swiss Federal Banking Commission makes even more extensive use of outside auditors, requiring them to undertake annual supplemental (and confidential) reports with respect to regulatory compliance. These reports are comparable to what the SEC’s Office of Compliance Inspections and Examinations might have produced, but the Swiss personnel who undertake these reviews do not show up on government payrolls.

Similar problems of completeness exist in collecting comprehensive data on enforcement outputs. For example, in evaluating enforcement efforts in the UK in the 2000s, one would have wanted to consider both the oversight functions of the Financial Reporting Council mentioned above and also the Financial Ombudsman Service, which provided mediation services for a large number of matters each year, but whose enforcement actions were not included in FSA’s own enforcement data. One should also probably take into account the predilection of some regulatory bodies to resolve enforcement actions informally and without public disclosure. Again, this is a common practice for the British FSA, but it is also employed by many other jurisdictions, including, for example, Switzerland, where many enforcement actions are reported only on an anonymous basis.37

**Misdirection**

By misdirection, I mean the possibility that both publicly reported regulatory resources and enforcement outputs may not actually be intended to produce supervisory services. To begin with, there is an obvious question of whether all resources allocated to regulatory agencies are in fact employed in bona fide supervisory functions, as opposed to serving as sinecures for cronies of political elites or positions from which to extract bribes and other economic rents. While all of the major financial centres of the world—the USA, the UK, Hong Kong, Luxembourg, Singapore, and Amsterdam—do report above-average levels of regulatory staffing and budgets, one can also find some more surprising jurisdictions (like Nigeria and Jordan) that report devoting substantial resources to regulatory agencies.38 The possibility of graft and sinecures may produce non-trivial levels of ‘noise’ in measures of regulatory input, especially for evaluations that include the developing world.

One might also imagine similar misdirection in reported enforcement activities, if, for example, financial sanctions were being imposed to penalize political opponents of the parties in power, or to punish industry participants for failing to pay bribes to regulatory officials. While this may seem to be the kind of problem one would

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37 One might also note a reciprocal problem of over-inclusion. In some jurisdictions, the task of corporate oversight is combined with securities matters—both Germany and Australia shared that characteristics. And so simple comparisons of actions brought against firms and their officers and directors would not have been fully comparable to SEC actions in the USA, where corporate matters are left to state laws. A similar problem would arise with respect to the jurisdictions of consolidated supervisors, such as the British FSA or German BaFin, whose responsibilities (unlike the SEC) extend to banks and insurance companies.

38 See Jackson and Roe (n 33).
encounter only in seriously corrupt jurisdictions, there is a possibility that the concern is more widespread. In the USA, for example, the monetary penalties imposed in the early 2000s by state authorities, led by former New York Attorney General Eliot Spitzer, materially increased the level of overall US monetary sanctions. The most uncharitable critics of Mr Spitzer claimed that these actions were at least partially motivated to advance his own political ambitions; if true, the inclusion of these actions in aggregate US data could confound analysis that proceeds on the assumption that all monetary sanctions are imposed to deter wrongful market behaviour.

**Inadequate granularity**

One can easily imagine improving basic staffing data to provide greater granularity to the subject of regulatory inputs by examining the portion of regulatory staffs dedicated to enforcement activity. One could, for example, decompose the allocation of staffs into supervisory building blocks of rule formulation, examination and inspection, enforcement, and other sectors. While one would face considerable challenges in assembling such data—currently regulatory agencies are remarkably eclectic in job classifications, and the lines between examination and enforcement often blur—the development of more refined staffing data would be of considerable interest. One might, however, imagine other ways in which to subdivide regulatory personnel to generate equally interesting granularity. The professional backgrounds of regulatory personnel vary substantially across jurisdictions. The SEC traditionally hires many lawyers and accountants; in contrast, the British FSA employed more economists and high-level staff drawn from industry ranks. There are also differences in the extent to which regulatory personnel move back and forth between industry and government, as opposed to staying largely within a civil service path. In addition, the degree to which regulatory personnel turns over with changes in political leadership varies a good deal across jurisdictions. It is not entirely clear which staffing decisions are most closely tied to strong financial markets, but to the extent that staffing allocations are significant then one might want to examine the relationship on multiple dimensions.

One could also make similar distinctions with respect to enforcement actions and penalties. In most jurisdictions, regulatory officials have jurisdiction over a wide range of activities—including the quality of corporate disclosures, insider trading and market manipulation, the sales practices of securities firms, and a host of technical rules regarding financial institutions’ solvency and the technical operation of markets. The distribution of enforcement efforts varies a good deal from jurisdiction to jurisdiction, with the SEC placing more emphasis on the review of disclosure documents and enforcement actions against other issuers than do other jurisdictions. And, of course, the incidence and distribution of private enforcement actions against both issuers and securities firms varies from country to country. Aggregate data about overall enforcement actions and sanctions may obscure important differences across enforcement categories.

Understanding the mechanisms of enforcement

Even assuming the SEC could have assemble data, with an appropriate degree of granularity, about the real resources allocated to legitimate public oversight of financial markets and the associated measures of formal enforcement actions, the Commission might still have been a long way from divining whether a particular jurisdiction’s level of regulatory intensity ensures an adequate level of compliance or sufficient oversight to foster robust capital markets. The linkage between regulatory intensity and positive economic outputs is not well understood and may vary from jurisdiction to jurisdiction.\(^\text{40}\)

Consider, for example, the possibility that the regulated entities in one jurisdiction—think Sweden—are more apt to comply with newly promulgated legal rules than their counterparts in other jurisdictions—say Italy. This commonly accepted stereotype of the North–South European divide would imply that fewer enforcement actions are necessary in some jurisdictions than in others in order to generate the same impact on private market behaviour. One does not, however, need to posit trans-jurisdictional variation in inherent lawfulness in order to have concerns about the comparability of enforcement efforts from one country to the next. The means by which regulators enforce legal requirements may well differ materially around the world. The light-touch regulation of the now defunct British FSA included numerous mechanisms of public–private exchange, ranging from the raised eyebrow on official Albion foreheads to the quite complex network of advisory committees and consultations that characterize British supervisory practices. Somewhat similar in effect is the use of informal guidance in Japan. All of these alternative mechanisms of social control are plausible substitutes for the formal enforcement actions that characterize the regulatory activity in the USA and a few other jurisdictions. The relative scarcity of enforcement actions in these other jurisdictions does not necessarily imply greater non-compliance or economic drag.

It is also important to examine the relationship between public enforcement efforts and private sanctions. Private litigation in the USA often follows on the heels of public sanctions. And thus the significance of public enforcement efforts in the USA, as compared with the UK or Germany, may be even greater than the raw numbers suggest. However, litigation may not be the only, or even the most, important private response to public enforcement actions: market movements in the form of price declines for shares and career consequences for implicated individuals may be far greater. Plus, to the extent that violators are public firms, the proxy process and voting power may impose additional sanctions on management. At this stage, most of the work done on market reactions to public enforcement efforts has focused on US markets; thus we do not know whether foreign markets impose similar knock-on sanctions. It is, however, conceivable that in some foreign jurisdictions private monitors do a better job of amplifying public sanctions than do US markets. In London, for example, shareholders are said to have more power in the boardroom and so

\(^{40}\) For a recent overview of empirical studies of the impact of public enforcement on the quality of financial markets, see Jackson and Zhang (n 35) above. Almost all of the scholarship reviewed in this study was produced after 2008 and thus would not have been available to the SEC at the time of its original experiment with substituted compliance.
British investors may respond to British sanctions more effectively than their US counterparts respond to SEC sanctions.

**Globalization and enforcement**

Globalization also complicates comparative evaluations of enforcement data on many dimensions. Cross-listed firms are one case in point. If one considers the number of enforcement actions in Canada and adjusts for the relative size of the Canadian market, one would likely conclude that the level of securities enforcement in Canada is substantially lower than in the USA. However, it turns out that quite a large number of leading Canadian firms are cross-listed in the USA, and therefore are also subject to many US regulatory requirements, supervisory standards (including exchange oversight), and even private liability rules. Accordingly, the Canadian system of securities oversight does not constitute the entire universe of legal constraints on a major portion of the Canadian stock market. To some degree, Canadian securities markets free-ride off of US regulatory intensity.

The increasing collaboration across jurisdictional boundaries complicates our evaluation of national regulatory efforts in other ways as well. With the globalization of financial markets, regulatory officials routinely refer matters to their counterparts in other jurisdictions. Often, a problem like insider trading or market manipulation will be detected in one market but will be referred to a second or third jurisdiction, where the investor making the trades or the firm in whose stock the trade is affected is located. Referrals of this sort happen hundreds and perhaps even thousands of times each year, and greatly expand the investigatory powers and enforcement reach of national regulatory authorities. For many jurisdictions, these cooperative arrangements may substantially enhance their regulatory capacity beyond those suggested by the countries’ own supervisory forces.

A similar point can be made about the development of new regulatory policies and legal standards. In the past, such activities were largely conducted independently at the national level, with relatively little cross-border collaboration. In recent times, however, a relatively small number of jurisdictions—the USA and the UK being the most prominent examples—have dedicated substantial resources to policy analysis and the development of new rules for emerging issues such as hedge funds and derivatives transactions, and then have shared their conclusions with other jurisdictions (often with the assistance of multilateral bodies, such as IOSCO or the Basel Committee, or regional treaty arrangements, such as the EU). As a result, smaller countries—even those with quite substantial financial markets—benefit from policy and rule development occurring beyond their borders. Analyses that focus solely on local resources miss this important regulatory networking.


42 See, eg, <http://www.sec.gov/about/offices/oia/oia_crossborder.shtml#mechanisms> accessed 12 October 2015 ('In fiscal year 2011, the SEC made 772 requests to foreign authorities for enforcement assistance and responded to 492 requests from foreign authorities.').
How else might we measure the adequacy of regulatory intensity?

How might we go about determining whether the USA or some other jurisdiction was devoting adequate resources to supervising and policing financial markets? While comparisons of regulatory staffing and budgets, or overviews of enforcement intensity, may help identify instances where a country differs dramatically from international standards—as does the USA in the case of securities class action suits—these measures of regulatory inputs and outputs are likely to be too crude to make sharp distinctions across a wide range of jurisdictions. What other measures of quality exist? In my view, there are two plausible, alternative approaches. I describe each below, again making references to the kinds of data that would have been available to the SEC at the time it was negotiating its original substituted compliance.

The first would focus on technical measures of financial performance.\(^4^3\) With respect to corporate issuers, one might consider the cost of capital across jurisdictions on the assumption that if domestic firms within a jurisdiction can raise capital at reasonable prices, that jurisdiction must have a reasonably acceptable legal system to oversee the issuance of securities, or, at least, local markets must have developed adequate mechanisms to police serious agency costs by corporate insiders or controlling shareholders. Or one could look at objective measures of the degree of earnings manipulation in stock prices (see Figure 6).\(^4^4\) In a similar spirit, one could look to the behaviour of trading markets—bid-ask spreads, price synchronicity, and evidence of trading on inside information—to draw inferences about regulatory quality (see Figure 7).\(^4^5\) The evidence of equity premiums for cross-listed firms has similar probative value, but is potentially available for only a limited number of jurisdictions—the USA, the UK, and perhaps Hong Kong or Luxembourg—which attract substantial numbers of cross-listings. The vast majority of national stock markets do not compete for foreign listings, and are quite happy if they can simply retain their domestic firms.

Another metric for evaluating financial markets can be found by examining the behaviour of market participants. This kind of evidence was often cited in debates of the last decade over US capital market competitiveness. The declining number of new foreign listings and the spike of foreign firm deregistrations in the latter half of 2007 have been seen as evidence that American regulation had become too onerous. Conversely, one could see evidence of a rising number of new foreign listings as a measure of the quality of those markets that actively compete for foreign listings. More widely applicable would be a market test based on the increasing presence in foreign markets of institutional investors (as well as retail investors) from the USA and other developed nations. When sophisticated institutional investors make substantial investments in a country’s financial markets and...

\(^{43}\) The analysis in this subsection draws on several suggestions from my colleague Professor Allen Ferrell.


Figure 6. Average level of earnings management (derived from Leuz et al. 2003).

Figure 7. Country-level $R^2$, sorted by GDP, 1995.
depend on that market’s trading systems and support mechanisms, such as custodial services and clearing arrangements, that confidence represents another source of market-based information on the quality of foreign markets and may well have some probative value in corroborating the quality of local regulation and legal regimes (see Figure 8).46

**A multifaceted approach (and an opportunity for self-reflection)**

So what analysis would we expect to see the SEC undertake in evaluating the regulatory systems of Australia and other jurisdictions? The short answer, I think, is that no single approach would suffice. Clearly, the Commission would want to ensure itself that an appropriate and comprehensive system of legal rules are in place. And reputational considerations as well as past experience in regulatory cooperation would also be important. Analysis of regulatory intensity—both in terms of regulatory inputs and outputs—also has undoubted value. But one must be careful to draw the comparisons accurately with considerable attention to institutional variation across jurisdictions. Confident normative judgments about the implications of observed variations in regulatory intensity should await empirical validation. One should also consider evidence available from objective measures of quality that are more directly tied to financial performance, as well as the additional information one

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can derive from observing how market participants, both corporate issuers and sophisticated institutional investors, vote with their feet and their dollars.

An important, incidental benefit of these cross-country comparisons will be the opportunity they provide for domestic self-assessment. In developing objective standards for reviewing other countries, the US regulators could have an opportunity to consider the efficacy of its own system of regulatory oversight. In addition, it will have the opportunity to consider whether the highly complex and expensive system of regulation that has evolved in the USA is actually necessary to maintain effective oversight of a modern economy.

**ADDITIONAL PROBLEMS IN APPLYING A SYSTEM OF SELECTED SUBSTITUTE COMPLIANCE**

Let us accept for a moment that the Commission could have developed some reasonably objective and well-grounded system for determining the adequacy of regulatory oversight in other jurisdictions. And assume further that this system ascertained that a dozen or so financial regulatory systems around the world do actually measure up to the SEC’s standards of quality and comprehensiveness. What other issues might arise in accepting foreign oversight as a substitute for domestic oversight? In my mind, there are several potentially important issues to consider.

**Limits on the exportation of supervisory services**

In certain areas of financial oversight, the efficacy of financial services might not travel well across large distances. This is not so much a problem for disclosure requirements that are quickly impounded into market prices around the world nor is a problem of policing home country market venues to which foreign investors are given access. But it could be an issue for supervisory standards applicable to market conduct, for example, governing the manner in which securities firms do business with retail customers. One source of difficulty could lie in the fact that home country regulators could have trouble detecting violations involving foreign customers in remote locations. Defrauded foreign investors could also face geographic constraints in utilizing dispute resolution procedures—for example, the ombudsman operations of the British authorities—from a distance. Yet another problem could be the political imperatives driving regulatory operations, whereby the threat of political repercussions could lead home country authorities to focus their supervisory efforts on activities that affect home country constituents and not the victims of misconduct who reside outside of the local political system.47

These potential difficulties suggest attention needs to be given to ensuring that supervisory attention is appropriately extended to foreign markets that rely on off-shore oversight. One could imagine utilizing local authorities—for example the SEC or even US state securities commissions—to convey customer-facing information about potential problems back to home country officials. And, the original Tafara–Peterson proposal envisioned a requirement of pre-existing memoranda of understanding to deal with precisely this issue. But, further attention needs to be given to

47 Jackson (n 14).
monitor the actual extension of supervisory oversight to foreign markets and perhaps
even include expanded consumer complaint services and dispute resolution proce-
dures to ensure that the full set of home country protections follow regulated firms
and transactions into foreign markets.

The problem of regional confederations
Another unique set of concerns arise when mutual recognition procedures are ex-
tended into regional confederations, such as the EU, which are themselves built on
inter-connected systems of mutual recognition among member states. The issue here
is ascertaining which is the appropriate entry point for cross-border collaboration.
On the one hand, the SEC could have considered the EU as a possible point of con-
tact. As a result of the EU internal market initiative, all member states are required to
organize their local financial regulations in accordance with EU directives, and con-
siderable effort has gone into ensuring that all member states, even the new entrants,
have complied with this process. So the consideration of the formal legal require-
ments with the EU would be relatively straightforward. The problem comes, however,
when one gets to the more difficult questions of regulatory intensity and quality of fi-
nancial markets. Here there is considerable variation, especially between the larger
and well-established markets in London, Frankfurt and other traditional financial
centres, as compared with certain southern European jurisdictions and the new
member states in the East or along the Mediterranean. On almost any plausible met-
ric of objective performance, regulatory resources, enforcement efforts, objective in-
dicia of market performance or presence of foreign investors, the distance between
the better developed and less developed European markets is substantial.

The variation in supervisory and market quality militates in favour of a focus on
individual member states as a preferable point of contact, starting for example with
the UK or perhaps Germany as likely partners for initial European linkages. But the
problems of regional confederation do not fully disappear. The genius of the EU in-
ternal market is the free flow of goods and services, which permits issuers located in
one jurisdiction to list their securities in another member-state markets and allows fi-
nancial services firms to branch across the region’s boundaries. Thus, even if the
Commission were to conclude that market oversight within a single EU jurisdiction
was comparable to that of the USA, concerns would still arise whether products sold
in that countries market and all firms doing business in that market were fully subject
to the member states oversight.

These inconsiderable difficulties may explain why the Commission chose to un-
dertake its first experiment in mutual recognition with Australia, which maintains
largely a free-standing national system of financial regulatory oversight (albeit one
with fairly close ties to New Zealand) and its second with Canada, which though
complicated by a federalized structure has a close and long-standing history of regu-
larly cooperation with the USA.

Potential limitations on the scope of accommodation
Limitations on the scope could also have been an element of any new system of US
recognition. Partially, these limitations might have been used to deal with the
Commission’s inability to satisfy itself of the quality of all aspects of a jurisdiction’s
supervisory system. This issue might arise, for example, with respect to objective measures of stock market efficiency that might well vary between large and small sized companies. In the face of such evidence, one might imagine the Commission to allow foreign brokers to offer US customers only the securities from issuers above a certain size or for similar limitations to be imposed on the securities included on remote exchange terminals placed in the USA.

Somewhat different limitations might be imposed on arrangements involving member states of the EU, perhaps limiting cross-border transactions with US customers to those securities and other financial products fully overseen by the signature member state. So, for example, if the UK entered into the first such arrangement with the SEC, then the sale of securities in UK listed firms might be eligible for sale to US customers but perhaps not structured products listed on the Frankfurt exchange and then passported into UK markets.

Yet another and more radical kind of limitations would be to restrict the kind of US investors eligible to purchase securities or otherwise do business with foreign firms operating under these new arrangements. Such an approach would, in essence, convert mutual recognition into a new modified form of institutional or accredited investor exemption. But, as it would entail an evaluation on the quality of foreign supervisory oversight, it would still represent a manifestation of the new regulatory paradigm. (This limitation is, actually, how the SEC–Australian Mutual Recognition Agreement would have dealt with cross-border activities of foreign securities firms.)

**Domestic political consequences and reactions**

Finally, a few words on several political dimensions of the SEC’s aborted foray into this new regulatory paradigm.

First are claims for ‘equal treatment’ on the part of domestics firms and issuers. One of the premises of substituted compliance is that somewhat different foreign regulatory regimes can provide acceptable alternatives to domestic arrangements. The key operational consideration, which has been the focus of much of the foregoing discussion, is how a domestic regulatory agency such as the SEC should go about determining which foreign systems have obtained acceptable standards. But from the perspective of domestic regulated firms, the most striking aspect of these arrangements is that foreign entities are allowed to do business locally without complying with the same domestic standards as have been applied under our traditional system of modified national treatment. Hence, local constituents are quite likely to argue that some or another feature of domestic regulation should be relaxed to equal foreign rules on the subject or at least that domestic firms should be granted the option of complying with either the domestic or the foreign standard on various issues. A good example of this response arose in the debate over whether US domestic issuers should be allowed to prepare their financial statements in accordance with IFRS instead of traditional US GAAP.

These pleas for equal treatment pose a challenge for the new paradigm. The danger of acquiescing in piecemeal accommodations of this sort is that specific elements of foreign regulatory structures may depend on the presence of other regulatory elements that do not exist in the USA and cannot easily be replicated. For example, the clubby atmosphere of the City may allow British authorities to rely on more
open-ended regulatory principles than might be necessary in America’s large and anonymous financial markets. Or the relatively law abiding nature of German firms may explain BaFin’s ability to rely on outside auditing services rather than the kinds of regulatory examinations that the SEC typically conducts. In other words, the distinctive institutional context of certain foreign markets may be essential to the less stringent regulatory requirements that exist in those markets.

Of course, not all aspects of foreign supervisory structure will be so intricately connected to other unique features of local regulation, and so domestic constituents may often seek accommodations that are both sensible and necessary to allow for fair competition. Indeed, one of the virtues of substitute compliance is that it can facilitate productive forms of regulatory competition. The trick of course is for regulatory authorities to be able to distinguish regulatory adjustments that move the race upward and not downward.

A related concern involves no changes in domestic regulation but movement of domestic firms and transactions to offshore markets that are eligible for substitute compliance. Just as domestic US corporations have long been permitted to move their corporate seat to Delaware in order to reap the benefits of that state’s corporate laws, US issuers and financial services firms might contemplate relocating offshore to operate under an alternative regulatory market while still doing business with US customers. Whether such relocations should be permitted—or how strenuously they should be policed—raises another political complexity for domestic regulators. As with the selective adoption of foreign oversight, the movement of domestic corporations to nominal offshore locations can dilute or compromise regulatory standards. If, for example, issuer supervision in a foreign jurisdiction depends in part on the presence of local institutional investors with large block holdings, that regulatory system may not work as effectively for a relocated foreign firm with few or no large block holder resident in the foreign jurisdiction. On the other side, once again, is the possibility that jurisdictional choice might improve the quality of supervision in both jurisdictions. The proper balance of these considerations again is likely to vary from context to context.

A final political consideration is the likely reaction when the first scandal arises involving a foreign firm operating domestically but under the primary jurisdiction of home country oversight. Such situations will no doubt arise, and will no doubt generate intense political scrutiny of the agency and officials who allowed the foreign firm to enter under such arrangements. The treatment of these political recursions is one of the great impediments to moving towards a system of substituted compliance, as the officials who champion the reforms have much to lose from adverse political reactions down the road. One partial solution to such adverse political repercussions is to ensure that appropriate dispute resolution and compensation arrangements are available for injured parties, especially individuals of moderate means. Another form of insulation is to maintain good records of the incidence of failures and losses for comparable domestic firms in order to be able to place the problems generated by foreign entities into a larger context. But the potential of negative publicity and political backlash from future scandals under this new regime is an important political factor that must be acknowledged and, to the extent possible, addressed.
CONCLUDING THOUGHTS ON SECOND-GENERATION SUBSTITUTED COMPLIANCE

In this final part, I offer some preliminary reactions to more recent applications of substituted compliance on the part of the Commodity Futures Trading Commission (CFTC) and the SEC. These developments are more completely described in a companion article by Alexey Artamonov, and the following points are intended to explore the relationship between the original visions for substituted compliance articulated in the Tafara–Peterson article—what I call first-generation substituted compliance—with the doctrine’s current incarnation, rather than a complete treatment of recent developments.

The financial crisis and first-generation substituted compliance

I begin with a short review of the demise of original Tafara–Peterson framework. What brought the SEC’s experiment with first-generation substituted compliance to a halt was the Global Financial Crisis of 2008. Distractions of the crisis itself plus the burden of drafting and implementing regulatory reforms that followed would likely have been sufficient to explain the SEC’s abandonment of its experimental framework with Australian authorities. But several specific feature of the crisis also challenged the theoretical underpinnings of these reforms. With first-generation substituted compliance, the focus of attention was on whether foreign-regulated securities firms and stock exchanges should be allowed entry into US markets and access to US investors. The flow of business was in-bound and the critical concerns were over whether investor safeguards from foreign regulatory schemes could provide comparable protection to US residents. The financial crisis demonstrated that extraterritorial regulatory failures could communicate losses across national boundaries without any prior direct contact with domestic retail markets. Simply limiting interactions of foreign firms with large local institutional investors proved inadequate to insulate the larger economy from cross-border effects of financial distress. (After all, problems in US subprime mortgage markets were communicated around the world largely through institutional investors.) The 2008 failure of Lehman Brothers also suggested that the scope of comparability assessments contemplated in the original Tafara–Peterson framework may have been too narrowly tailored to the adequacy of foreign consumer protection regimes and insufficiently attentive to other matters including the adequacy of resolution regimes for firms operating across national boundaries. Consideration of solvency procedures, custodial arrangements, and a variety of other back office issues might also be of critical importance. In short, the financial crisis revealed that the focus of first-generation substituted compliance on the adequacy of consumer protections in foreign regulatory regimes was arguably excessively narrow in terms of safeguarding national interests.

The emergence of second-generation substituted compliance

Perhaps surprising in light of first-generation substituted compliance’s fate as one of the Global Financial Crisis’s first regulatory casualties has been the emergence of second-generation substituted compliance over the past few years. The details of this process, championed in the USA by both the SEC and the CFTC, are discussed in
detail in Alexey Artamonov’s article, and so I will limit myself to few preliminary words about how this new application of substituted compliance differs from the approach’s earlier incarnation. Most importantly, second-generation substituted compliance is applied in an out-bound context. That is, its application is not premised on offshore firms seeking access to new customers—whether retail or wholesale—in the USA. Rather the second-generation regime is primarily designed to provide exemptive relief to foreign entities and activities that are being subject to the extraterritorial application of new statutory provisions adopted in the Dodd–Frank Act of 2010. In other words, second-generation substituted compliance offers regulatory relief from the out-bound application of new regulatory requirements. This distinction between in-bound and out-bound explains why substituted compliance today has a quite different feel to foreign jurisdictions. With the original Tafara–Peterson version, foreign jurisdictions and firms would voluntarily apply for comparability determinations in order to gain access to US markets. The regime was optional for those who chose to participate. With second-generation substituted compliance, regulatory relief is still being granted, but it is in the form of an exemption to the mandatory extraterritorial application of US laws. Foreign entities can escape the requirements of US law but only by reorganizing business activities so as to avoid US jurisdictional triggers. Second-generation substituted compliance offers not so much a novel benefit conferred as an unwelcome penalty avoided.

Another difference between first- and second-generation substituted compliance is the nature of the markets involved. As the application of second-generation substituted compliance is in the context of derivatives and swaps transactions, the US jurisdictional contacts for the extraterritorial application of the Dodd–Frank Act requirements primarily or in some cases exclusively involve the sort of institutional investors that would previously have been exempted from the kinds of retail-market requirements that Tafara–Peterson style substituted compliance was designed to address.48 Of course, since the goal of these Dodd–Frank Act reforms was to police systemic risks, whatever the source, it is not surprising that the extraterritorial application of the Act’s requirements for derivatives (as well as other regulatory reforms such as the Volcker Rule) would push out further than traditional SEC investor protection requirements. It is, however, striking that second-generation substituted compliance—at least as practiced by the SEC and CFTC—involves primarily institutional markets, whereas the old-style Tafara–Peterson version was focused, primarily, on the expansion of foreign access to retail markets.

The evolution of comparability assessments
Another distinction between first and second-generation substituted compliance is the nature of the comparability assessments involved. The approaches differ in several ways. In the original Tafara–Peterson formulation, the central focus was on regulatory inputs. As set forth in the margins, the Tafara–Peterson framework offered a

48 As discussed above, foreign issuers and even foreign broker-dealers had ways to access large institutional investors in the USA even without first-generation substituted compliance.
fairly granular list of regulatory requirements that the foreign jurisdictions would be expected to address in order to gain favourable comparability assessments. While the Tafara–Peterson framework was also attuned to the importance of assessing enforcement practices, this first-generation approach to substituted compliance quite clearly emphasized regulatory inputs.

Second-generation substituted compliance—as formulated by both the CFTC and the SEC—puts comparability of regulatory objectives at centre stage, explicitly eschewing ‘rule-by-rule’ comparisons. So, for example, the SEC articulates its approach as follows:

[T]he Commission is proposing to take a holistic approach; that is, we would ultimately focus on regulatory outcomes rather than a rule-by-rule comparison. Substituted compliance therefore should accept differences between regulatory

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49 This framework envisions a four-step process. The second step would involve a discussion [which] would involve a bilateral assessment to determine the degree to which the two jurisdictions’ trading rules, prudential requirements, examinations, review processes for corporate filings, and other requirements are comparable. The comparability assessment would also involve a discussion of enforcement capabilities and philosophies. Tafara and Peterson (n 19) 58 (emphasis added).

Exchange Oversight
A comparability assessment would contain, at a minimum, an assessment of how the foreign regulatory regime regulates its stock exchanges to determine how its requirements vary from those the SEC requires of U.S. exchanges. In particular, this would involve a comparison of: the two different jurisdictions’ registration, authorization, and other forms of licensing of exchanges; how customer funds are protected from misappropriation and misapplication; the foreign regulator’s recordkeeping, reporting, and electronic audit trail requirements; exchange governance and internal compliance; the exchange trading rules and the exchange rule approval process. Ibid 60 (emphasis added).

Broker-Dealer Oversight
A comparability assessment for foreign broker-dealers seeking an exemption from registration in the United States would also include comparisons of the foreign jurisdiction’s registration, authorization, and other forms of licensing; minimum financial requirements for persons that accept customer funds; protection of customer funds from misappropriation and misapplication; recordkeeping, reporting, and electronic audit trail requirements; and internal compliance requirements for broker-dealers. It would also include a comparison of the SEC’s and foreign jurisdiction’s minimum sales practice standards, and minimum disclosure requirements with regard to potential broker-dealer conflicts of interest. Ibid 60–61.

Issuer Requirements
In addition to comparing regulatory requirements for both exchanges and broker-dealers, the proposed comparability assessment would review disclosure requirements relating to securities bought or sold on an exchange or through a broker-dealer. This would include a comparability assessment of financial and non-financial statement disclosure requirements, the robustness of the accounting standards required in the jurisdiction, the adequacy of local auditing standards, and auditor oversight controls. It would also entail a comparability analysis of other issuer requirements designed to ensure that issuer disclosures are accurate and complete. Such requirements might include a comparison of the jurisdiction’s corporate governance, internal controls, director independence, and shareholder protection laws and regulations. Ibid 61 (emphasis added).

regimes when those differences nevertheless accomplish comparable regulatory outcomes . . . .

[W]e do not envision that the Commission, in making a comparability determination, would look to whether a foreign jurisdiction has implemented specific rules and regulations that are comparable to rules and regulations adopted by the Commission. Rather, the Commission would determine whether the foreign regulatory system in a particular area, taking into consideration any relevant principles, regulations, or rules in other areas of the foreign regulatory system to the extent they are relevant to the analysis, achieves regulatory outcomes that are comparable to the regulatory outcomes of the relevant provisions of the Exchange Act.\footnote{Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants; Proposed Rule, 78 Federal Register 30,968, 30,975, 31,086 (proposed 23 May 2013) (to be codified at 17 CFR pts 240, 242, 249).}

The CFTC has adopted a similar formulation.\footnote{See Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations; Rule, 78 Fed Reg 45,292, 45,342-43 (26 July 2013) (to be codified at 17 CFR pt 1) (‘Significantly, the Commission will rely upon an outcomes-based approach to determine whether these requirements achieve the same regulatory objectives of the Dodd-Frank Act. An outcomes-based approach in this context means that the Commission is likely to review the requirements of a foreign jurisdiction for rules that are comparable to and as comprehensive as the requirements of the Dodd-Frank Act, but it will not require that the foreign jurisdiction have identical requirements to those established under the Dodd-Frank Act.’).} While the original Tafara–Peterson proposal identified comparability of regulatory objectives as a threshold requirement,\footnote{See Tafara and Peterson (n 19) 59 (‘The Commission’s determination whether to exempt [a foreign firm] . . . would first require as a prerequisite an assessment by the Commission of the comparability of the entity’s home jurisdiction regulation and the ability of this home jurisdiction regulation to achieve the same objectives mandated by federal securities laws.’)} it also contemplated quite detailed reviews of legal rules and regulatory requirements.

Another difference between the two generations is the level of generality at which the comparability assessments are made. The original Tafara–Peterson framework was to be applied to fairly large areas of regulation: broker-dealer regulation, exchange market regulation, and issuer disclosure rules. As Alexey Artamonov’s article explores,\footnote{See Artamonov (n 1) 212–14.} second-generation substituted compliance also includes some general categories, such as entity level requirements and transactional requirements, but then organizes comparability assessments around more discrete regulatory objectives, four in the case of the SEC and thirteen in the case of the CFTC.\footnote{For a helpful comparison of the SEC and CFTC approaches, see Jonathan Lindenfeld, ‘The CFTC’s Substituted Compliance Approach: An Attempt to bring about Global Harmony and Stability in the Derivatives Market’ (2015) 14 Journal of International Business and Law 125, 145–46. See also Christian Johnson, ‘Regulatory Arbitrage, Extraterritorial Jurisdiction, and Dodd-Frank: The Implications of US Global OTC Derivative Regulation’ (2014) 14 Nevada L J 542.} The relatively large number of discrete regulatory objectives make it somewhat more difficult to envision how second-generation substituted compliance would incorporate the kinds of objective outcome-based comparability assessments that I described earlier as potentially
available for first-generation substituted compliance. While various metrics are available to assess the efficiency of capital markets or the quality of trade execution, it is more challenging to find measurements of the quality of chief compliance officers or trading documentation, to take two of the CFTC’s categories for comparability determinations. Of course, even if empirical metrics were available for these category determinations, US authorities would have difficult applying those metrics to their initial comparability assessments as the foreign regimes are still being put into place and data on their efficacy is likely to be quite limited. Conceivably, when comparability assessments are to be reviewed in several years’ time, better data may well be available, although the problem of finding appropriate metrics will persist. Alternatively, US authorities could attempt to make comparability assessments around some more general measures of supervisory quality, such as assessments focused on the systemic risks associated with particular foreign regimes or even industry assessments of counter-party risk in various jurisdictions. To be sure, the costs and benefits macro-prudential regulation are notoriously difficult to quantify. There are, however, a number of data sources and performance metrics that might be invokes to calibrate the efficacy of different regulatory regimes, and it could be fruitful exercise for both the SEC and the CFTC to start planning for how they might more make future comparability assessments at both the entity and transaction level once numerous foreign regimes are in place.

**Common themes in first- and second-generation substituted compliance**

Having flagged several major differences between first- and second-generation substituted compliance, let me now comment upon several recurring themes, which feature in both generations in similar though not always identical ways.

*Enforcement capabilities as an enduring criterion*

One area of commonality between first and second-generation comparability assessments is a focus on enforcement capabilities and philosophy. In neither context did

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58 See ibid.


61 Cf Tafara and Peterson (n 19) 58 (‘The comparability assessment would also involve a discussion of enforcement capabilities and philosophies.’), and ibid 61 (‘In addition to an assessment of the home
US regulatory authorities articulate exactly how efficacy of enforcement capacity would be determined and in neither context have officials made reference to the kinds of enforcement inputs discussed above in the context of first-generation substituted compliance. But it is clear that enforcement comparability assessments as well as strong cross-border coordination through memoranda of understanding and other mechanisms stand out as important components of both first- and second-generation substituted compliance.62

The influential role of the USA
As portrayed in the original Tafara–Peterson article, one of the virtues of substituted compliance was the capacity it gave the USA to influence the structure of foreign regulation to comport with US standards in order to gain access to the USA. Second-generation substituted compliance has that aspiration as well, but—as Alexey Artamonov explains,63—a key mechanism for the USA to achieve this effect has been to have its approaches to derivatives and swaps regulation adopted first into international standards sanctioned by the G-20 and Financial Stability Board (FSB) and thereafter into national laws, sometimes via EU mechanism of implementation. By enlisting multilateral organizations in this manner, the USA is better positioned to impose second-generation substituted compliance on foreign sovereigns and can quite plausibly claim to be insisting on only compliance with internationally agreed upon standards. Plus, as Alexey Artamonov’s proposal suggests,64 the presence of overarching international standards raises the possibility that compliance determination could be made, at least in the first instance, by international entities, such as the IMF or FSB, a possibility that did not exist with first-generation substituted compliance, which anticipated comparability determinations with respect to uniquely American regulatory requirements.65
Extraterritorial application of foreign regulatory capabilities

Another common theme for both approaches to substituted compliance is the complexity of ensuring that foreign regulatory regimes operate effectively with respect to activities that take place in the USA. As discussed above, this was a problem for first-generation substituted compliance with respect to the application of foreign broker-dealer supervision to protect customers injured in the USA and a long way away from home country supervisory staff. While second-generation substituted compliance is a matter of providing exemptive relief to out-bound applications of US laws, there are circumstances in which the new regime contemplates the application of foreign legal requirements to employees or branches of foreign firms located within the USA. In these contexts, that application requires imposition of foreign regulatory systems into US territories, including potentially the assignment of examination personnel to US localities. While not impossible, such special extensions of foreign regulatory systems can be challenging and raise the concern noted above with respect to first-generation substituted compliance that there could be some dilution of supervisory strength in cross-border contexts, even if the regime operates comparably in home markets.

Capital mobility as a critical design components

Finally, I would note that concern—and to some degree of uncertainty—over the potential for capital mobility underpin policy discussions over both first- and second-generation substitute compliance. With first-generation substitute compliance, a central concern was that US retail investors as well as institutional investors were moving offshore to engage in capital market transactions largely outside the US regulatory protections. First-generation substituted compliance was designed to repatriate those transactions and (ideally) encourage the stiffening of supervisory oversight oversees up to standards approximately those of the USA. In other words, the task was to combat the emerging fragmentation of global capital markets. The design challenge for the SEC was making the standards of comparability sufficiently flexible so as to encourage national authorities to converge on US standards, but not so lenient as to undermine investor protections. With second-generation substituted compliance, the SEC and CFTC face a similar dilemma; they want to insist on regulatory safeguards sufficient to address systemic risk concerns, but not so strict as to facilitate the creation of the sort of fragmented and unstable sub-markets of the sort that Alexey Artamonov fears.