

Institute of  
International  
Finance, Inc.



Proposal for a  
**Strategic Dialogue on Effective Regulation**

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# IIF Special Committee for a Strategic Dialogue on Effective Regulation

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\*Sir George Mathewson, former Chairman of the Board of the Royal Bank of Scotland Group PLC, made a substantial contribution as an initial co-chairman of the Special Committee.

# IIF Special Committee for a Strategic Dialogue on Effective Regulation

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## Why the Proposal for a Strategic Dialogue on Effective Regulation?

Josef Ackermann, Chairman of the Management Board and the Group Executive Committee, Deutsche Bank AG; IIF Chairman:

*“We are now moving forward with a long-term, far-reaching dialogue between financial services firms and their regulators with the aim of developing more effective and efficient approaches to regulation. The principles are designed to achieve a better overall international regulatory process on a sustained basis, as well as address specific issues of mutual concern to both the industry and regulators.”*

William Harrison, Chairman of the Board, J.P. Morgan Chase & Co.; IIF Board Member:

*“This is the first time that the global financial industry has put forward a set of **Guiding Principles** to frame relations with the regulators and to place them on a more consistent footing across the globe. Our work on application of the principles will initially stress three areas of particular importance where concerns exist – global coordination of regulatory policies; enforcement practices; and anti-money laundering issues. Inefficiencies in these areas can best be addressed through cooperative efforts.”*

Peter Wuffli, Group Chief Executive Officer, UBS AG; IIF Board Member:

*“We have recognized that the most constructive way to advance the mutually shared goal of regulatory efficiency in global financial markets is to move ahead with a dialogue between leaders of globally active firms and senior officials of the regulatory community. This will help assure focus on the common objectives of supporting a vibrant, growing, and competitive global economy and ensuring financial system stability, while building mutual understanding on how best to streamline and improve the efficiency of regulation across national borders.”*

Charles Dallara, Managing Director, Institute of International Finance:

*“The need for a strategic approach at this time reflects in part an increasing contrast between the rapid pace of globalization of financial firms, and markets and regulation that remain rooted in national policies and legislation. We believe that a long-term dialogue can facilitate a process of adaptation by both regulators and firms to new global realities, building on the cooperative efforts already under way.”*

Proposal for a

## **Strategic Dialogue on Effective Regulation**

- I. Introduction and Overview
- II. Shared Aspirations: A Common Agenda
- III. Guiding Principles
- IV. Contributions and Responsibilities
- V. Examples of Effective Regulatory Interaction

## I. INTRODUCTION AND OVERVIEW

In an effort to strengthen interaction between regulators and the financial services industry, an IIF Special Committee chaired by William Harrison and Peter Wuffli, consisting of senior private-sector leaders and former regulators, has developed this *Proposal*.

Sound regulation is of fundamental importance. Financial services firms and regulators have a common interest in a regulatory environment that supports economic development and growth, financial stability, customer service, and consumer protection. While high-profile lapses in effective controls certainly called for appropriate responses, there is increasing concern that complexity and uncertainty in the current regulatory environment may impede achievement of core regulatory objectives. This *Proposal* is founded on certain key beliefs arising from this concern:

- Ability to serve customers better can be hindered by legislative, regulatory, and enforcement uncertainty and by excessively prescriptive approaches.
- Overly detailed regulations are not well suited to maintaining regulatory effectiveness as market practices evolve rapidly.
- Inconsistent regulations and uncoordinated supervisory practices across borders and sectors diminish regulatory efficiency and create unnecessary burdens for both regulators and firms.
- Regulatory safeguards are threatened when rules for market conduct, risk management, and customer protection do not apply equally to regulated and unregulated firms offering comparable products and services.

- Legislative and regulatory processes that do not include adequate industry and other stakeholder input during the conceptualization and rule-making processes may not maximize efficiency or may result in unintended consequences for customer service and the economy.
- Disproportionate enforcement action can create unintended effects that may have broader regulatory or economic implications for the entire industry.

The IIF applauds the efforts that many in the public sector have made to recognize and to address these challenges through a variety of initiatives currently being pursued. Nevertheless, the IIF believes that addressing these concerns requires moving beyond discussion of specific regulatory initiatives to a broader, forward-looking focus on the overall interaction between financial services institutions and regulatory authorities. The IIF *Proposal* is to establish an ongoing, strategic dialogue between the two groups, focused on a clearer appreciation of common goals, effective and efficient regulatory approaches, and methods by which these objectives can best be achieved.

Discussions of drafts of this paper with the Financial Stability Forum (FSF), the Joint Forum, the OECD Committee on Financial Markets, and heads of regulatory agencies have enhanced the Special Committee's understanding of the issues.

Moreover, such discussions—which will continue following publication of this *Proposal*—confirm commonality of interest in achieving more efficient and effective international regulation and interest in constructive dialogue at the most senior levels of firms and regulatory agencies. The FSF's press release reporting its September 2006 meeting reflects the significance and importance of this continued engagement:

*“The Institute’s Proposal is a welcome initiative, which has the broad support of the FSA. Too much of the rhetoric in the past has focused on an essentially adversarial relationship between regulator and regulatee. That should not be the case. The Proposal represents a constructive approach to improving these key relationships. The challenge now—for regulators and those regulated—is to advance from good intentions to counter results.”*

—Sir Callum McCarthy, Chairman, Financial Services Authority, U.K.

*“As a global business it is critical for Citigroup to operate in a regulatory environment globally that emphasizes consistency and efficiency while at the same time respecting the responsibilities and role of national regulators. The Institute’s **Proposal** provides a sensible and practical set of principles to that end. We look forward to working with regulators around the world to advance our common agenda of promoting a strong, competitive, healthy, and responsible global financial system.”*

—Charles O. Prince, Chairman and Chief Executive Officer, Citigroup

*Effective and efficient regulation. As part of their ongoing dialogue with market participants, [FSF] members exchanged views with representatives of the Institute of International Finance (IIF) on how regulation could be made more effective and efficient, and discussed ways to further enhance the dialogue between regulators and the financial industry. The Forum welcomed the IIF’s efforts in this regard and noted that financial services firms and regulators share a common view of principles that underlie good regulatory practice. Noting existing examples of effective interaction, the FSF encouraged the IIF and other private market participants to raise issues of market weakness and other important regulatory issues that warrant attention, and regulatory bodies to continue their dialogue with the IIF and other market participants on specific issues.*

- Deepening understanding of the international dimensions of regulatory practices and requirements and enhancing international communication and cooperation among regulators.
- Making regulation more effective by identifying and rectifying unduly burdensome or counterproductive practices or approaches.
- Addressing the cycle of complexity, whereby market responses to regulation lead to further, more detailed regulation rather than to a review of the goals of the original regulation.
- Fostering a dialogue on effective regulation that can meaningfully inform legislative and public discussion of regulatory issues.
- Promoting enforcement policies that recognize good-faith compliance and avoid retrospective application of changes in regulatory and market practice.

The IIF sees the following concrete benefits to both regulators and industry from this initiative:

- Deepening industry understanding of the fundamental objectives of regulatory bodies and regulatory understanding of industry structures and approaches.
- Improving focus on the origination and development of clearly targeted policies, as well as on their implementation.
- Supporting existing public-sector efforts to improve regulation and establish best-practice approaches to meeting regulatory objectives.

The views expressed in this *Proposal* have been refined through extensive dialogue both across IIF members and with a number of leading members of the regulatory community. In addition, a formal survey of IIF members’ CEOs was undertaken to deepen the inquiry and confirm its broad validity.

Simultaneously with this *Proposal*, the IIF is developing more detailed papers on specific topics to amplify this necessarily brief discussion.

*“The FSF welcomes the IIF’s efforts to enhance dialogue between regulators and the financial industry on regulatory issues and market weaknesses that warrant attention. Financial regulators and financial services firms share a common view of principles that underlie good regulatory practice.”*

—The Honorable Mario Draghi, Governor, Banca d’Italia, and Chairman, Financial Stability Forum

*In order to test the Proposal against the views of the broader membership of the Institute, a survey of member CEOs was taken in the summer of 2006. Comments were taken into account in revising the present document. CEO responses suggested the following rankings of the concerns addressed. The summary below suggests the contours of members' assessment of these concerns at the present time.*

## **Assessment of Concerns**

### *Issues of broad-based and major concern*

Unnecessary complexity owing to "over-engineering" of regulations
Inconsistencies in treatment across jurisdictions
Efficiency of regulation: Costs and burdens proportionate to results?
Hindering ability to serve customers

### *Issues of serious but more selective concern*

Overall effectiveness of regulations in achieving shared aspirations
Inconsistencies in treatment across firms
Disproportionate or unreasonable enforcement techniques

## **Importance of Proposed Guiding Principles**

### *Proposed Guiding Principles of broad-based impact*

Emphasizing collective and market-based solutions
Fostering mutual trust and respect for judgment
Promoting global coordination
Assessing policies and new initiatives dynamically

### *Proposed Guiding Principles of more selective impact*

Supporting meaningful legislative dialogue
Promoting proportionate enforcement
Emphasizing contingency planning

*“In my experience chairing the IIF’s Steering Committee on Regulatory Capital, the constructive dialogue between the Basel Committee and industry has been one of the most important factors in advancing a new capital framework that is increasingly aligned with market practice. I believe that the Institute’s Strategic Dialogue will be instrumental in bringing industry and supervisors together in a consultative, transparent approach to the broad thrust of regulation in all areas of financial services.”*

—Stephen K. Green, Group Chairman, HSBC Holdings plc

## II. SHARED ASPIRATIONS: A COMMON AGENDA

Both firms and regulators have a strong, shared interest in developing and maintaining an effective set of relationships that:

- support economic growth and competition;
- ensure financial-system stability and security; and
- serve customers’ best interests with clear safeguards.

The IIF believes that these three broad public objectives provide a common agenda for action.

### *Economic Growth and Competition*

Regulation should support the health of the financial system and global economy as a whole and encourage development of competitive financial markets.

- *Healthy, innovative, and profitable financial firms.* Successful institutions that invest in innovations that benefit customers improve the efficiency of the financial system and are less likely to develop problems of solvency or liquidity or to contribute to financial disturbances. They are also more likely to devote an appropriate level of institutional resources to issues with broader social benefits.
- *Open and competitive markets and non-discrimination.* Entry to markets should be dependent only upon prudential standards and fitness and proper conduct criteria. Regulatory requirements should not advantage one type or class of firm (e.g., domestic or international, state-owned or

privately owned, publicly traded or mutual, regulated or unregulated). Legitimate public interests need to be recognized, but solutions should be prudential, not protectionist.

- *Customer-driven products.* Open competition is the best means of promoting good customer service and sensitive response to customer needs. Regulation should not inhibit the market from responding to customer needs.
- *Organizational flexibility.* Regulation should neither favor nor require any specific organizational or ownership structures, except as necessary for appropriate fitness, proper conduct, and transparency.

### *Institutional Safety and Soundness*

Regulation and supervisory oversight should foster the optimal level of structural soundness, financial prudence, and risk control in all participants.

- *Prudential capital maintenance.* Regulation should ensure that capital maintenance and utilization requirements are prudent without unduly restricting business activity.
- *Sound risk management.* Regulation and supervisory oversight should reflect and heavily rely on the governance and control systems of institutions. Regulation should encourage effective risk management within groups, regardless of the legal entity structures of local offices.
- *Counterparty transparency.* Regulatory approaches should support the capacity of market participants to assess counterparty and investment risks via meaningful disclosure.

*“The industry and the regulators share an interest in effective regulation, but they also feel what I call ‘mutual frustrations’ about the less-functional features of cross-border regulation today. That is why the focus on trust and respect for judgment in the Institute’s Guiding Principles is key to achieving a better system that can produce tangible benefits for the global financial system.”*

—Roger W. Ferguson, Member of the Executive Committee and Head of Financial Services, Swiss Re, and Chairman, Swiss Re America Holding Corporation

- *Prevention of financial crime/Money laundering.* Regulation should assist financial institutions in combating financial crime effectively and efficiently and in promoting the overall security of the financial system. Prevention of money laundering and terrorist finance is as much a priority for firms as for governments. Regulators should aim to help ensure that the substantial resources devoted by the private sector to this priority are used effectively.
- *Crisis prevention and management.* Regulation should promote contingency planning at institutional and industry levels without creating moral hazard.
- *Effective dispute resolution.* Regulation should place reliance on firms’ dispute-resolution processes in dealing with customers. It should protect consumers’ rights without creating excessive litigation exposures.
- *Product availability.* Regulation should not restrict product availability without a compelling justification and should rely on fair, timely, and useful disclosure wherever possible.

### III. GUIDING PRINCIPLES

The IIF believes that the interactions between regulators and the financial industry should be shaped by a set of Guiding Principles. These can be stated simply as follows:

#### *Customer Service, Protection, and Care*

Regulation should foster appropriate levels of customer service, protection, and care.

- *Customer privacy.* Regulation of privacy and customer data should give customers confidence in the confidentiality of their financial information, supporting legitimate law enforcement without unduly burdening legitimate business activity.
- *Customer choice.* Regulation should reflect the responsibilities of customers for their own affairs and recognize the differing needs and capabilities of different customer segments and markets.
- *Customer awareness.* Regulation should foster useful disclosure to customers proportionate to their needs, commensurate with their sophistication, and appropriate to the transaction. Industry and regulators should support financial-education efforts for the public.
- *Mutual trust and respect for judgment* is the foundation of effective regulation.
- *Collective market-based solutions* should be preferred whenever possible.
- *Global coordination of regulation* is an essential part of any jurisdiction’s regulatory process for firms conducting cross-border business.
- *Maintaining a meaningful legislative dialogue* is essential for both industry and regulators.
- Effective and efficient regulation requires *assessing policies and new initiatives dynamically*.
- *Contingency planning* is an ongoing, joint obligation of the public and private sectors.
- *Proportionate enforcement* must be part of efficient and effective regulation.

*“The IIF’s Proposal represents an important initiative that can help move us further down the path of more effective regulation. In particular, I welcome the emphasis on strengthening cross-border coordination, which has been a key theme of the Basel Committee on Banking Supervision for many years.”*

—The Honorable A.H.E.M. Wellink, President, De Nederlandsche Bank, and Chairman, Basel Committee on Banking Supervision

The Institute’s thinking on these principles is as follows:

*1. Mutual trust and respect for judgment is the foundation of effective regulation.*

Regulatory organizations and financial institutions should develop and maintain mutual trust in and respect for the judgments of each other. Regulators must also develop mutual trust in and reliance on other regulators, both in other sectors and across borders.

Greater trust implies greater transparency and accountability.

- It is essential that financial institutions be, and be seen to be, operated in a responsible and ethical manner with appropriate resources devoted to corporate governance and risk control activities. Financial institutions should be expected to develop their own high standards of behavior consistent with regulatory principles and objectives, and should be assessed on the quality of the judgments that they make over time.
- A consistent pattern of responsible and ethical conduct by firms should help lay the basis for a relationship based on mutual trust.
- Regulators should have greater scope to exercise their own judgment and discretion in assessing whether and when to impose sanctions to create appropriate incentives and improve practices.
- It is equally essential that regulators and legislators discuss regulatory objectives and new initiatives both with the industry and with their coun-

terparts in other jurisdictions. This improves the identification of regulatory objectives and the quality and effectiveness of regulatory policy.

At a general level, the IIF is supportive of “principles-based” regulation, but is realistic about what this entails. Principles-based regulation requires more dialogue, greater willingness by regulators to make and to stand by judgments of what constitutes acceptable compliance, and readiness by firms to accept those judgments. Firms must undertake corresponding responsibilities both in setting internal expectations and in managing the needs of line officers for guidance. It is nonetheless worth pursuing, since principles-based approaches, though perhaps not feasible in very specific circumstances, can generally be expected to keep pace with the rapid evolution of the global financial markets in a way that detailed, legalistic rules and checklist-based regulation cannot.

*2. Collective and market-based solutions should be preferred whenever possible.*

For regulators, working cooperatively with the industry to *anticipate, preempt, and resolve emerging issues* offers greater efficiency and flexibility than does the issuance of detailed regulations. A recent example of effective industry action and cooperation in response to regulatory concern was the concerted industry effort to address infrastructure issues in the credit derivatives market. Firms should take more responsibility for bringing issues of broad or systemic importance forward for discussion with regulators, or for initiating market-driven solutions, before issues become acute and while there is the opportunity to participate in formative thinking on responses.

*“It is no longer feasible to achieve change through national approaches applied only to the home institution of the home country. Effective solutions to many of the concerns we face in our national financial systems will require multilateral approaches.”*

—Timothy F. Geithner, President and Chief Executive Officer, Federal Reserve Bank of New York

*“Effective and efficient regulation of financial systems is key to ensuring growth, incomes, and jobs. We welcome the efforts of the IIF and other bodies that help us better understand and address the challenges now facing us.”*

—Timothy D. Adams, Under Secretary for International Affairs, U.S. Treasury

Voluntary industry codes can facilitate market-based solutions that relieve pressure on supervisory resources. Such codes, generally based on disclosure and incorporating “comply or explain” provisions, may be officially recognized and can bridge the gap between principles and the common desire for interpretative safe harbors. This helps avoid the slide into rigid rules that may result from requests for official guidance about principles.

Beyond voluntary codes, formal self-regulatory organizations may be the right response on certain issues.

Wherever collective action is contemplated, with or without direct regulatory involvement, thought must be given to the competition law implications of agreements or concerted work on market problems by competitors. It may be appropriate for regulators to contribute to the process by helping define ground rules or reaching understandings with competition authorities.

Market discipline can provide meaningful oversight of firms’ behavior if adequate transparency is provided on a consistent and comparable basis. While it is clear that market oversight alone cannot achieve all of the goals of financial-industry regulation, further opportunities to rely more on market oversight should be explored aggressively. To this end, industry and regulators should work to make sure that regulatory disclosure requirements result in useful and comparable information. Industry users of information should assist regulators to avoid disclosure requirements that do not produce useful information.

*3. Global coordination of regulation is an essential part of any jurisdiction’s regulatory process for firms conducting cross-border business.*

Financial institutions, financial markets, and the global regulatory community are adapting to the globalization of financial activities over the last two decades. Historical patterns of regulation and local regulation of global groups are still prevalent. More focus is required at the national and international levels to adapt existing regula-

tion to these changes. The process of adaptation should reflect risk-management and corporate-governance processes in global firms.

Different approaches across and within jurisdictions make it difficult for regulators to rely on each other’s work. This impedes shared oversight. There are still substantial differences of supervisory style and approach. The industry and the regulators should work to reduce these differences over time. Complete harmonization of rules and regulations, let alone regulatory culture, is impractical in the short run, but much more could be done to develop greater international consistency, coordination, and mutual reliance.

Global coordination initially must be based on mutual confidence between international regulators rather than attempts at promoting formally identical rules.

- Considerations of international consistency and the general advancement of international regulatory cooperation should be central to the development and assessment of any new domestic regulations. To the greatest extent possible, regulators of local units of groups should accept home country rules and group models and procedures as applied by the group, particularly with respect to wholesale activities and transnational markets. In those cases, such as certain consumer matters, where local rules must be applied, lead regulators for international groups should accept local rules in local markets, as long as substantive regulatory goals can be achieved by locally appropriate means.
- Regulators of group members should work together closely and share information with lead regulators and with each other. There should be much greater emphasis on common metrics, common reporting formats, and common standards for review and for the documentation that would accompany these reviews.

- Mutual recognition—based on economic results, not legalistic forms—of generally comparable regulatory compliance efforts, disclosures, or supervisory decisions (e.g., with respect to approval of internal models for regulatory capital calculation) should be the norm rather than the exception. At a practical level, such cooperation will in time lead to a higher degree of trust and communication.

A means to improve cooperation and dialogue would be to broaden the “colleges of supervisors” organized on a group-by-group basis for Basel II implementation. Making such colleges permanent for international groups could be a significant benefit both for groups and for the regulatory system.

As the President of the Federal Reserve Bank of New York said recently, “In a more integrated global market, we will increasingly find ourselves compelled to pursue borderless solutions.” The pace of integration and innovation in global markets makes it increasingly difficult to solve problems with “a local or national solution,” as has been recognized by leaders of the UK Financial Services Authority, the Federal Reserve Bank of New York, and the US Securities and Exchange Commission in their *Financial Times* article on September 28, 2006.

#### *4. Maintaining a meaningful legislative dialogue is essential for both industry and regulators.*

Financial regulation is a product of the legislative process, but the pace of innovation in financial markets contrasts with the generally deliberate pace of change in legislation. Legislators, industry, and regulators alike are thus often frustrated by outdated or ill-adapted legislation. An effective, timely legislative process is therefore an integral component of effective and efficient regulation. From the IIF perspective, three related aspects of the legislative process are important.

First, the legislative framework must permit regulation to change as the global financial system changes. Consideration of these changes must include a process of review of existing legislation aimed at removing elements that are outdated or have lost their effectiveness.

Second, regulators and firms should work closely with legislators to ensure appropriate demarcation between

those elements of the regulatory framework that are best addressed directly by legislation and those best left to regulatory and supervisory processes. This will require open, transparent discussion among firms, regulators, and legislators. (The “Lamfalussy Process” in the EU and the delegation of details to implementing rules in the US go a substantial way in this direction.)

Third, legislators should clearly articulate objectives at the commencement of the legislative process. There must be an opportunity at that stage for constructive dialogue on strategic priorities as to how these objectives can most effectively be achieved, and this dialogue must include legislators, regulators, the industry, and other stakeholders. This dialogue must always consider whether it is clear that there has been a failure of the market or activity or conduct in the industry that is threatening to the public interest and for which no other public policy response is likely to be effective.

#### *5. Effective and efficient regulation requires assessing policies and new initiatives dynamically.*

Public consultation processes regarding new regulatory initiatives are the norm in many jurisdictions. However, this consultation is frequently over the details of implementation rather than on the policy aims to be pursued and the most effective means of pursuing them. Furthermore, it often comes too late in the process of developing public policy.

More systematic consideration should be given in any new initiative to (1) defining the specific objective of the initiative, usually on the basis of a clearly identified failure of the market that creates a risk to the system, to investors, or to consumers; (2) the resources that will be required (both from regulators and from firms) to implement it in practice; (3) whether alternative approaches exist (e.g., collective industry action) for achieving the same objective; and (4) how the effectiveness of the initiative in addressing its objective will be measured and assessed over time.

There should be a continuing impact assessment process with regular reviews of existing regulations. The review process should recommend remedial actions taken when a regulation has ceased to perform its intended function effectively. Although costs and benefits are often hard to quantify, and impacts should not be assessed solely or

*“The IIF’s Proposal is very much in line with our efforts in CEBS to promote convergence of supervisory practices and to reduce the inefficiencies that currently exist. Thus, I strongly welcome these proposals and look forward to working together to put them in effect.”*

—Danièle Nouy, Secretary General, French Commission Bancaire, and Chairman, Committee of European Banking Supervisors

even primarily on the basis of narrow efforts at quantification, considerable academic and regulatory attention has been given to impact assessments in recent years. This work needs to be encouraged and developed. The IIF perceives that a number of regulations currently in place are not viewed as highly effective even by the regulators charged with administering them.

Consultative dialogue should be continued through all phases of the process.

*6. Contingency planning is an ongoing, joint obligation of the public and private sectors.*

Both regulators and industry have a common interest in taking measures to minimize the systemic disruption that could be caused by extreme events. Regulation in this area should be evaluated by comparing the resources required to meet a regulation to the marginal effect of that regulation on whether a financial disturbance would be contained or become systemic. In the view of the IIF, greater collective, forward-looking discussion of emerging risks by senior regulators and financial industry leaders offers a better return than current regulations that consume resources of banks and regulators disproportionate to their likely effects.

Contingency arrangements should have a more prominent role in such discussions. Every simulation of such events, not to mention the real-life cases, reveals the need for additional cross-border planning and communication. Central bank and regulatory participation in such tests can be on an active or consultative basis.

*“We need an environment of mutual trust and dialogue between the supervisory community and industry in order to build a transparent, efficient global supervisory framework. The Institute’s Guiding Principles are a solid basis on which the right kind of public/private dialogue can be built to advance a more efficient supervisory structure.”*

—Charlie McCreevy, European Commissioner, Internal Market and Services

<sup>1</sup> In certain non-G10 countries, the ability of regulators to enforce existing rules on an effective, efficient, fair and predictable basis may still be lacking. Developing such capabilities to international standards is a priority. Such countries need rapid and sure enforcement against wrongdoing, sufficient means to assure fair and accurate enforcement, and clarity of enforcement norms. Such countries also have an opportunity to put in place truly efficient and effective means of enforcement that avoid some of the problems discussed in this paper.

There often is a reluctance to plan too much or too openly in advance so as to maintain some amount of “constructive ambiguity” and avoid the risks of moral hazard. However, this needs to be balanced against the risk of miscalculation and the need for swift responses in a crisis, especially in circumstances where communication channels may be disrupted. At the least, the relative pros and cons deserve to be re-examined openly in light of ongoing changes in the integration of global financial markets.

*7. Proportionate enforcement must be part of efficient and effective regulation.*

It is in the interest of end users, firms, and their regulators that intentional wrongdoers be punished effectively.<sup>1</sup> Nonetheless, enforcement procedures, in addition to being fair and transparent, should be well integrated in the overall regulatory strategy and process.

Mandatory penalties abridge regulators’ ability to exercise reasonable judgment to design proportionate responses to issues as they arise. Mandatory or automatic penalties should be discouraged and avoided in the legislative process.

In many countries, certain enforcement decisions are lodged with entities other than the regulators (e.g., ministries of justice). If not well integrated with the overall approach to regulation, these enforcement decisions can disrupt rather than enhance the development of regulatory practice and the achievement of public policy objectives by creating sudden changes in expectations and

potentially creating new avenues for excessive litigation. The IIF believes that structured dialogue and active cooperation between regulators and other enforcement agencies is a prerequisite for effective regulation. In cases where financial regulators have the power to bring both administrative and criminal proceedings, it is necessary for such regulators to formulate enforcement policy that satisfies both civil and criminal policy requirements and also respects the nature of the supervisory relationship, where openness may be a key objective.

As with everything else, enforcement is no longer a purely domestic event. It may not be clear where the center of gravity of an alleged violation should be understood to be situated. As has been suggested by enforcement authorities, attention should be given to international understanding on whether, where, and how enforcement actions involving international questions should be brought.

The intersection of the regulatory system with private litigation is closely related to enforcement. While exploitation of enforcement proceedings for purposes of private litigation has been most characteristic of the US system, private litigation is common to all legal systems. Private litigation is sufficiently unpredictable that regulators sometimes do not consider exposure to private litigation as a facet of regulatory enforcement. Regulators should, however, recognize that litigation risk affects firms' behavior, market efficiency, and innovation and should avoid any action that unduly increases firms' exposure to litigation, for example, by imposing regulations that place a burden of proof on firms to show that they did not act inappropriately. Additionally, alternative modes of redress for aggrieved clients should be promoted within the regulatory system whenever possible, for example, by providing non-litigation dispute-resolution or arbitration procedures.

All of these considerations are aspects of the fundamental principle that enforcement should only be undertaken in concert with considered regulatory strategy. Enforcement decisions can lead to de facto "step-change" devel-

opments in regulation that are difficult to manage and unfair for well managed firms. If a bad actor has violated well understood legal norms or regulatory principles, the rest of the industry should not suffer for it. Regulatory change should take place through the consultative processes discussed in this document, with reasonable time allowed for implementation and adjustment of people and systems to change, not through enforcement decisions that in effect suddenly and unpredictably modify rules, interpretations, or accepted market practices.

## IV. CONTRIBUTIONS AND RESPONSIBILITIES

This section outlines steps that financial institutions and regulators can take to achieve the objectives identified in this document. (It is important to look at the "firm" or "institution" from the group perspective. The values suggested here should exist throughout the group, regardless of branch or subsidiary forms of organization.)

### 1. *Responsibilities of firms and their managements*

- **Ethical Leadership.** Financial institutions and their senior leadership in particular should approach their roles in a responsible and ethical fashion, making judgments about business activities on the basis of high standards of market conduct and customer treatment, not solely on the basis of what is prevailing market practice. High standards should be expected and enforced throughout the group.
- **Effective Governance.** Financial institutions should ensure that relationships between executive management and group boards of directors support effective decision-making, foster necessary "checks and balances", and are consistent with a long-term perspective on the market and franchise value of the firm.
- **Effective Risk Management.** Financial institutions must monitor, evaluate, and manage key risk exposures on a well integrated basis.

*"In recent years we have seen growing tension between the global nature of markets and firms and the national roots of regulation. These new **Guiding Principles** can contribute to a course for addressing those tensions and for advancing greater consistency in cross-border regulation."*

—Tom de Swaan, Senior Advisor to the Managing Board, ABN AMRO N.V.

*“Without moving more quickly toward convergence of supervisory standards and practices, and toward a more streamlined supervisory framework in general, banks like BNP Paribas will not be able to achieve all of the potential synergies that should be possible. Such synergies are in the interests of not only the industry but also the regulators and the global economy in general. The Institute’s Proposal represents a dynamic, forward-looking approach to addressing the obstacles to convergence.”*

—Baudouin Prot, Chief Executive Officer, BNP Paribas Group

- **Proactive Interaction with Regulators.** Financial institutions need to respect the regulatory process, dealing openly with regulators. In addition, they should consider the benefits of seeking informal, ex-ante indications of likely views from their regulators when needed, for example, when assessing new products or business practices that may not fall within the scope of clear regulatory standards.
  - **Contingency Planning and Crisis Management.** Financial institutions should give an appropriate priority to contingency planning and have procedures in place for management of disasters and liquidity or other financial crisis events. When appropriate, firms should collaborate with regulators to develop and test contingency plans.
  - **Internal Control Environment.** Internal financial and risk controls within large financial groups must be reviewed continuously to ensure that they are comprehensive, robust, and capable of highlighting significant weaknesses.
  - **Public Disclosure.** Financial institutions with public capital or debt outstanding should tailor disclosure policies to promote understanding of the organization, its financial condition, and its risk management approaches. Disclosure should progressively focus on supporting effective market oversight.
  - **Prevention of Financial Crime/Prevention of Money Laundering.** Financial institutions should recognize their common interest in preventing abuse of the financial system for criminal purposes and devote reasonably necessary resources to this effort.
  - **Protection of Customer Privacy.** Customers have high expectations for the confidentiality of their financial information. For commercial as well as legal reasons, firms must make it a priority to justify the trust that customers place in them by applying measures to protect the privacy and security of customer data and to assume the required balance between personal privacy and other public policies on properly controlled data sharing.
  - **Fair Dealing with Customers.** Customers are entitled to be treated equitably under all circumstances. A financial institution should translate its sense of high ethical principles into practical arrangements for dealings with customers and not rely on compliance with minimum legal requirements.
  - **Participation in the Regulatory Process.** Financial institutions should consider it an obligation to participate in the opinion-forming process and to engage in dialogue on regulatory issues at each stage of their development, as well as to respond to formal consultations. This includes giving attention to legislative issues in the interest of effective and efficient regulation.
  - **Participation in Collective Industry Efforts.** Financial institutions have a responsibility to participate actively in industry-driven initiatives to address problem issues by developing voluntary standards and codes of conduct.
- ## 2. Responsibilities of regulators
- **Definition and Articulation of Goals.** The regulatory process should begin with a clear articulation of goals and priorities, often based on

*“So much business is now done by internationally active firms that achievement of greater consistency among regulators in relation to both domestic and cross-border business would yield substantial benefits in terms of the overall cost-effectiveness of regulation. The IIF proposals accordingly give consistency a high priority, and we look forward to working with regulators to move ahead.”*

—Sir David Walker, Senior Advisor, Morgan Stanley International

market-failure analysis. Industry consultation should begin as early as possible, preferably in the exploratory stages, before analysis is completed and before directions are set.

- **Periodic Assessment.** Laws and regulations should be based upon a thorough impact assessment and analysis determining that benefits will justify costs. Regulations should be put in place only when there is a demonstrated market failure or there is otherwise a clear need and other approaches to issue resolution have been validly discounted as insufficient or inappropriate. Impact assessment should be performed periodically on existing regulations. One way in which this can be achieved is for new laws to include sunset provisions. When unintended consequences of legislation or regulation become manifest, the public and private sectors should work together to address them.
- **Early Consideration of Implementation.** Likely implementation issues or difficulties should be considered from the beginning of the process, not left to be discovered after frameworks are set. The impact, and possible overlap, of all new regulatory initiatives for different purposes should be considered together, and regulators should work with the industry to achieve an orderly, manageable, and transparent implementation process taking into account different regulatory processes. Specific regulatory initiatives should not be looked at in isolation. Time should be allowed to embed new regulations once implemented, before changes are introduced or new projects commenced.
- **Regulatory Cooperation.** Regulators should act on a cooperative, coordinated, and, as far as possible, consistent basis. This should be true both between jurisdictions and among different regulators in the same jurisdiction.
- **International Awareness.** Regulators should aim to achieve international consistency when developing new regulations. Consistency with international regulatory patterns should be an *a priori* part of every regulatory needs analysis, not an afterthought. Regulatory convergence is not an objective for its own sake, but should be the goal when it contributes to more effective and efficient financial systems.
- **Coordination of Ex-Ante Clearances.** In addition, there should be a concerted effort to implement international “no-action” procedures, building on such procedures where they already exist at a national level, but expanded to make possible multi-jurisdictional ex-ante regulatory advice where appropriate for cross-border transactions or new-product development and dissemination.
- **Responsiveness to Informal Inquiries.** Regulators should welcome and seek to respond expeditiously to informal inquiries regarding interpretations of regulation and supervisory practice, recognizing that time is of the essence in transactions. Responses should be approached constructively, taking an open-minded view of innovation insofar as possible, and should be structured not to penalize firms for asking questions.

*“Asia is a vast and diverse region. That makes it all the more important to build global and regional regulatory convergence on a sound basis. The **Guiding Principles** set the right tone and cooperative spirit for a productive dialogue that can advance the necessary convergence.”*

—Nobuo Kuroyanagi, President and Chief Executive Officer, Mitsubishi UFJ Financial Group, Inc.

*“The environment in which we operate is changing so radically that we need a period of shared discussion and joint initiatives involving market participants and investors in order to improve our regulatory mechanisms and prepare for the future. I particularly understand the emphasis on the need to assess policies and new initiatives dynamically in the IIF’s Proposal. For the sake of efficiency, I would recommend that the dialogue between the regulators and the industry take place at the level of the relevant international organizations (IOSCO, IAIS, Basel Committee, etc.).”*

—Michel Prada, Chairman, French Autorité des Marchés Financiers and Chairman of the Technical Committee of the International Organization of Securities Commissions

- **Performance-Based Regulation.** Regulatory remediation and enforcement should be performance-based and conducted in a way that distinguishes among the individual characteristics, capabilities, and performance of firms to create clear incentives for appropriate conduct and equally clear disincentives for inappropriate conduct. Performance-based regulation also means encouraging firms to deal openly with their regulators and take advantage of opportunities for informal consultations. Regulators should make it possible for firms to approach them without fear of retribution through the enforcement process.
- **Recognition of Corporate Risk Management.** Regulatory supervision, wherever possible, should supplement rather than duplicate or replace the management processes and risk infrastructures of participating firms, using intervention only where necessary.
- **Proportionality.** Regulation, supervision, and enforcement should be implemented in a way that is proportionate to the issue to be addressed.
- **Coordination of Reasonable Enforcement.** Formal or informal consultation between enforcement authorities and regulators should take place both as to specific enforcement actions and as to regulatory and enforcement policy in general. Regulation should not inadvertently increase litigation exposures of regulated firms, and attention must be given to the implications of regulatory actions for private litigation. Enforcement agencies should not seek to substitute their judgment on regulatory policy issues for that of regulators, and regulators should act in accordance with general principles of fairness in undertaking enforcement actions. Mandatory penalties that preclude appropriate use of regulatory judgment in a context of performance-based supervision should be avoided. Regulatory change through enforcement actions should be avoided. Rather, enforcement should be a part of a well articulated regulatory strategy.
- **Managing Change of Regulatory Policy.** There should be an overall goal of avoiding “step change” in regulatory, supervisory, and enforcement requirements. Firms in good faith compliance should be allowed to make orderly adjustments to new expectations, without sudden regulatory, enforcement, or litigation traps.

*“Nordea has been a pioneer of highly integrated cross-border business in our region. Reducing cross-border inconsistencies and inefficiencies can look pretty daunting, but getting cross-border regulation right through global coordination and increased dialogue will pay huge dividends.”*

—Lars G. Nördstrom, President and Group Chief Executive Officer, Nordea Bank AB

*“In the Gulf, we have seen progress in quality of regulation as a result of Basel II. The Guiding Principles will be a useful tool to help us broaden and institutionalize a regional as well as national dialogue with the regulators. We have the opportunity to get international regulation right in this region, and every incentive to do so.”*

—Ibrahim S. Dabdoub, Chief Executive Officer, National Bank of Kuwait, S.A.K.

## V. EXAMPLES OF EFFECTIVE REGULATORY INTERACTION

*Note: IIF members have provided the following examples of cases where regulatory interactions have been substantially effective and consistent with the spirit of the Guiding Principles proposed in part III. These examples, which are not exhaustive of those suggested by IIF members, are intended to provide a constructive and concrete basis for discussion, but should not be taken as unqualified endorsement.*

*Better Regulation Concepts.* The European Commission’s *White Paper on Financial Services 2005-10*, while having the limitations of a statement of intent, has the virtue of being a clearly articulated plan to undertake regulation over the next five years on a considered, proportionate, restrained basis respecting market principles. Related UK work, including the FSA’s *Better Regulation Action Plan* of December 2005, has been breaking important new conceptual ground and needs to be examined and discussed widely. Several other European authorities are undertaking such initiatives, the French AMF’s recent lengthy consultation paper on the subject being one example.

Similarly, the Swiss EBK issued in the Fall of 2005 the very interesting and constructive *Guidelines for Financial Market Regulation*, significantly subheaded “the requirements for a reasonable, cost-conscious and effective regulation of the financial market.”

*Principles vs. Rules.* Several of the “better regulation” discussions now being conducted by leading regulators explore the benefits and burdens or uncertainties of moving to more principles-based regulation. The UK FSA has been particularly committed to a generally more principles-based approach, although discussions with industry on the specifics continue. Particularly notable are its initiative with the Joint Money Laundering Steering Group, allowing firms to rely on risk-based, industry-

driven guidance for AML compliance, and its “Treating Customers Fairly” program, which aims to apply the principles-based approach to retail regulation, including reliance on an ombudsman for some dispute resolution. While firms in the UK certainly have comments about aspects of these initiatives, they have the laudable goal of creating effective incentives for firms to do the right thing with less regulatory intervention.

*EU/CEBS Regulatory Transparency Concepts.* Building on European Directives and the work of the EC, CEBS has set important standards for regulatory transparency through its *Guidelines for Supervisory Authorities on Increased Transparency and Public Disclosure*, giving information on laws and rules adopted at the national level and ways in which member states have exercised options and national discretions, plus statistical data on regulatory matters. CEBS has, in accordance with its mandate, also published a detailed consultative paper on its roles and tasks.

*CESR Exploration of Regulatory Mediation.* Although the approach remains controversial in many respects, the Committee of European Securities Regulators has done seminal work on “mediation” of differences between international supervisors, particularly as applied to specific firms or products. Whether or how these concepts can be transferred to other sectors is unclear; but the effort to find ways to resolve conflicts that may needlessly create regulatory uncertainty is laudable. In due time, efforts should be made to translate the mediation concept beyond the EU to international situations, perhaps by formal or informal international agreement.

*Credit Derivatives Market Settlement Issues.* Settlement issues related to credit derivatives transactions were increasingly recognized as needing urgent attention. Yet, tangible progress on the issue was difficult to achieve on a unilateral basis by individual firms. The supervisory response of calling the key industry participants together

*“Supervisory approaches need to be risk-based. In order to achieve that, supervisors in every important financial center must engage in ongoing international dialogue on the effectiveness of regulatory actions with the full spectrum of domestic and foreign financial institutions affected by their actions. We need a logical, transparent approach that avoids unnecessary complexity.”*

—Eugen Haltiner, Chairman, Swiss Federal Banking Commission

and demanding progress on the basis of a common set of agreed metrics was thus both well prepared and largely welcome. It demonstrated how to address an important issue in an effective yet flexible manner and was coordinated internationally so that duplicative burden on the industry was minimized.

*Responses to Back-Office Crises.* The securities markets in the 1960s, the foreign exchange markets in the 1990s, and the credit derivatives markets today have confronted “back office” settlement and similar problems that posed real dangers of substantial losses or even systemic disaster. Concerted industry action, substantial investment, and pointed but ultimately restrained interest by the regulators have resulted in largely satisfactory results that have substantially reduced dangerous paperwork backlogs, “Herstatt risk”, and legal risks, while reducing operational costs over the longer run.

*Contingency Planning/Liquidity Exercises.* In several cases, firms and regulators have engaged in detailed simulation exercises of crisis events, including the impact of such events on critical operations and liquidity. These efforts require substantial advance planning on both sides and of course can never fully duplicate a true crisis environment. Nevertheless, firms that have participated in such efforts have found them to be enormously valuable in helping to understand the issues that would arise as well as the linkages between various developments.

*Know-Your-Client (KYC) Requirements to Prevent Money Laundering.* KYC continues to be a difficult issue, but there have been positive aspects of the process. The industry took up the challenge early by developing the Wolfsberg Principles on a collaborative basis, including the NGO Transparency International. Good ground-

work for international coordination and cooperation was done by the Financial Action Task Force based at the OECD. Wolfsberg and to some extent the FATF illustrate that application of the ideas in this document could help provide better regulation even in the difficult money-laundering arena.

*Enforcement Coordination.* Although the industry generally believes that enforcement issues continue to require greater coordination between regulatory authorities and enforcement officials, certain steps in the right direction have been taken recently. For example, the development of MOUs between the U.S. regulatory agencies and the U.S. Department of Justice for enforcement of AML requirements facilitates the necessary consultation between enforcement officials and regulators on enforcement decisions that have regulatory implications.

*Standard Cost Model.* An international “Standard Cost Model” network has been established in conjunction with the OECD’s “Red Tape Scorecard” initiative, providing an analytical framework for reducing administrative burdens broadly, not specifically in the financial-services industry. This is being implemented in several practical ways. For example, the Netherlands government has adopted the Standard Cost Model to measure and review administrative burdens, with a stated goal of reducing the net administrative burden by 25% from 2002 to the end of 2007. A specific organizational structure oversees the process.

*Initiative Finanzstandort Deutschland.* The IFD is a private-sector action group composed of representatives from all segments of the German financial sector. It operates in cooperation with the Federal Ministry of Finance and the Bundesbank. Since its founding in 2003,

*“In recent years we have seen a sharp expansion of regulatory rules that, though well-intended, often do not improve the effectiveness of regulation. This Proposal sets forth a road map for collaborative efforts of both regulators and bankers that can move us clearly down the path of more efficient regulation.”*

—Dermot Gleeson, Chairman, AIB Group

the IFD has developed numerous measures and projects intended to provide a stimulus for growth and has had a positive impact on consumers and companies.

*Coordination of Supervisory Approaches.* For the two large Swiss banks, the home country regulator and banking regulators in the two capital market centers most relevant to these banks (UK and USA) have initiated twice-yearly meetings to compare views, exchange information, and coordinate any necessary actions across a range of regulatory issues. Under the aegis of the Accord Implementation Group of the Basel Committee, certain home regulators have organized useful “colleges of supervisors” for their banks to coordinate implementation of Basel II. While coordination of Basel II implementation has thus far been very uneven, the work of the AIG and the best “colleges” point in the right direction. Additionally, the FSA and SEC have recently signed an MOU to strengthen cooperation in oversight and supervision of global firms through increased information sharing. While it remains to be seen how this will operate in practice, it does seem to point toward greater efficiency and effectiveness of coordinated cross-border regulation.

*PCAOB/EC Collaboration on Audit Regulation.* The US Public Company Accounting Oversight Board and the European Commission faced the task of developing new

regulations for auditors last year, the PCAOB under the Sarbanes-Oxley Act and the EC under the Eighth Company Law Directive. Although, from a legal point of view, each had to follow prescribed procedures and attain independently mandated ends, a concerted effort at coordination in drafting parallel, though formally distinct, bodies of regulation enabled the two agencies to create a substantial degree of congruence and to reduce the possible areas of conflict between bodies of regulation.

*Securities Industry Regulatory Transparency Efforts.* For some time now, IOSCO has been developing and propagating higher standards of regulatory transparency, making good use of input from the industry. A recent understanding between the US CFTC and CESR provides a limited but highly useful first step to showing how international jurisdictional issues can be made more transparent and understandable.

*Dialogue on Basel II Standards.* Over several years, the industry and regulators have engaged in a dialogue on new regulatory capital standards. The process has been characterized by unprecedented intellectual interaction and open exchange between the industry and regulators. In addition, the Basel Committee’s Accounting Task Force has helped to anticipate and to find practical solutions to frictions arising as a result of the simultaneous implementation of Basel II and International Accounting Standards.

## ADDITIONAL DISCUSSIONS

*The foregoing discussion of objectives, Guiding Principles, and responsibilities provides a framework and rationale for strategic dialogue between regulators and financial institutions. To achieve the IIF Special Committee's vision for this strategic dialogue, the next steps required will be to focus on a set of concrete topics where discussion and collaboration can make tangible progress.*

*The first round of discussions on the basis of the General Principles over the year preceding publication of this paper has shown that three areas seem especially ripe for further discussion – if not easy solutions – and the following comments are offered to help advance that discussion in areas that are crucial for industry and regulators alike. These discussions also constitute the first element of the Institute's response to the Financial Stability Forum's challenge to the industry to focus the ongoing dialogue concretely on "important regulatory issues that warrant attention."*

### ADDITIONAL DISCUSSION A:

#### ADDRESSING CROSS-BORDER ISSUES

The first Guiding Principle in the *Proposal*, "Mutual Trust and Respect for Judgment," refers not only to the trust and respect needed between the regulator and the regulated, but also to the increased trust and respect for judgment required for the international regulatory community to deliver coherent global regulation. The increasing tensions of cross-border regulation and supervision reflect the development of financial-services groups into truly global entities, the advent of Basel II and international accounting, efforts of International Organization of Securities Commissions (IOSCO) to globalize concepts of securities regulation, new insurance solvency regimes, and globalization in general. Issues are especially acute in countries where foreign-based institutions have a significant or dominant share of the market.

*Mutual Trust and Respect for Judgment.* Industry and regulators have spent countless hours discussing how to alleviate the "home-host problem," that is, the need to coordinate prudential supervision and investor/market/consumer protection on a cross-border basis; to avoid duplicative supervisory reviews that place strain on the scarce resources of both banks and regulators; and to

mitigate divergent supervisory standards. A medium-to long-term approach is needed to deliver better understanding, trust, information sharing, and allocation of responsibilities among regulators. These objectives go hand in hand with the need for greater accountability and transparency, which improve the identification of regulatory objectives and contribute to overall quality of the final legislative or regulatory product.

*Principles-Based Regulation.* Wider use of principles-based regulation, based on clear regulatory goals and focused on the areas of highest risk, would incorporate the necessary flexibility to allow industry to innovate and to compete on a level playing field. It would also be more consistent with international coordination than detailed national rule books. The dissatisfaction felt with divergent international rules stems from the resulting operational difficulties for firms. To deliver consistent, more principles-based global regulation and coordinate consistent interpretation, it is important to expand and enhance the level of current cooperation through international fora.

*Global Coordination.* A critical need identified in the *Proposal* is international consistency in supervision of financial services groups. Regulators and legislators should consider the international implications, including consistency, when developing domestic or regional regulations.

Recognizing that the work that the Basel Accord Implementation Group (AIG) and the Committee of European Banking Supervisors (CEBS), as well as IOSCO and the Committee of European Securities Regulators (CESR), have done to promote understanding and information sharing among supervisors has been extremely valuable, banks continue, however, to be frustrated by many-layered requirements across jurisdictions. International groups do not perceive sufficient progress in convergence of requirements or in mutual reliance on reviews conducted by other supervisors. Moreover, dialogue across jurisdictions seems to be aimed at accommodating all requirements, rather than at the most efficient result for a global financial system. It is also a concern that some host regulators apply local prudential rules to branches of international groups without regard to home regulators' oversight or the group's global compliance efforts, even within the same legal entity.

There is a need for the jurisdictions representing the largest financial markets to lead the way in finding real solutions to these concerns. More far-reaching change could be accomplished without sacrificing the quality and effectiveness of supervision or the accountability of national regulators. It will, however, require a greater willingness to contemplate changes in supervisory approaches, just as Basel II has required real changes in capital rules.

The establishment of colleges of supervisors for Basel II purposes has proved to be a positive step forward in supervisory dialogue and cooperation. A partial solution to the broader home-host problem would be to extend the supervisory colleges beyond their current Basel II functions. Many institutions believe that the colleges can only be an interim step, and that strengthening the role of the lead supervisor should be the goal, but disagreement about the goal should not be allowed to cut off real, pragmatic progress in the meantime.

While home-host concerns are a key priority in the banking sector, there is value in discussing these issues within a broader context, including in the securities and insurance sectors. Recent discussions of cross-border stock exchange affiliations, understandings on the cross-border reach of certain derivatives regulations, integrated agreement to work toward accounting convergence, and cross-border recognition of reinsurance cover are examples of important such issues within these sectors. A strategic view of cross-border issues is needed to focus broadly on how progress can best be made in aligning national regulation and supervision with the global nature of financial markets. That the time has come for such a strategic view is shown by the *Financial Times* article of Sir Callum McCarthy, Timothy Geithner, and Annette Nazareth calling for a “collaborative process” to find a “borderless solution” to the most urgent regulatory problems.

Fora such as the OECD’s Committee on Financial Markets have the opportunity of focusing the international community on making cross-border regulatory interaction more effective and of raising the priority of cross-border issues in all domestic as well as transnational discussions. With private sector interest and support, such efforts can create consensus around good practices, even if legal or political problems cannot be eliminated in the short run.

*Host-Country Dilemmas.* Groups generally want to maximize host regulators’ deference to, and reliance upon, the decisions of their home regulators. An obstacle to mutual recognition and reliance upon home supervisors is the dilemma faced by host supervisors with local responsibilities (and political accountability) who have limited resources but are charged with regulating arms of global firms. These supervisors may be reluctant to rely on the work of home supervisors, may require locally incorporated subsidiaries, and may ring-fence local capital and liquidity. There is no simple solution as long as “lender of last resort”, deposit guarantee, and systemic-crisis responsibilities remain unclear or conflicted.

The accountability of host supervisors should not, however, become a blanket excuse for inaction on cross-border regulatory problems. This would undermine the benefits that many jurisdictions have experienced from allowing cross-border activities in the first place. Financial markets are more complex and risk management activities more important than ever before. Thus the efforts required to ensure an effective and efficient approach to the allocation of supervisory responsibilities have similarly increased. However, achieving balance is not an impossible task. The problem must be approached with due regard for the negative impact that regulatory and supervisory inefficiencies can have on effective global risk management and liquidity management practices as well as business structures. If supervisory participants view home-host dialogues as a “negotiation” where success is measured by how little each has to alter existing national practices, it will not be surprising if their outcomes disappoint the expectations of market participants. While the existence of fora such as the Basel AIG show that regulators are aware of the need for coordinated regulation of international groups, significant opportunities for conservation of regulatory resources through cooperation remain.

*Domestic Interests/Global Needs.* Excessive domestic focus will increase, not decrease, systemic risk, even locally. International consistency does not require identical rules, structures, or approaches but does require pragmatism. Notwithstanding the difficulties, regulators can take the following steps to ensure greater consistency: (i) increased regulatory transparency, (ii) ex-ante consultation with regulatory counterparts around the globe (including willingness to look for informal means to maximize international consistency), (iii) ex ante and on-going

consultation with industry, and (iv) increased reliance on mutual recognition.

- *Increased Regulatory Transparency.* Without regulatory transparency, home-host coordination is not possible. Risk management and compliance by international groups become needlessly difficult. Regulators and, when applicable, legislators, should make public the goals of proposed regulations and the policy decisions behind existing ones. With clarity of regulatory goals, proposed rules, and specific regulations, home and host regulators can identify points of overlap or divergence, better sequence introduction of new rules, and prevent unnecessary duplication. Within the EU, CEBS has made strides to institutionalize regulatory transparency. IOSCO has been working on transparency in securities regulation globally, and the CFTC and CESR have developed transatlantic transparency on certain common topics. They have also made progress on international “no-action” decisions. However, much remains to be done, especially in emerging market jurisdictions.
- *Ex-Ante Consultation with Regulatory Counterparts Around the Globe.* Attempts to agree on international regulatory standards to be translated into national rules have met with mixed results. The Basel II process, for example, is at a critical juncture where the Accord that was agreed upon almost 24 months ago is in serious danger of fragmenting across the major jurisdictions. The tendency to slide from principles into inconsistent rules driven by parochial concerns must be resisted. However, other ex-ante international consultation processes, such as the informal EU/US alignment of new auditing standards, have overall avoided divergences.

What factors influence different outcomes? How can effective ex-ante consultation among home and host regulators become the expected norm? Such consultations must face squarely the tension between domestic and global regulatory concerns.

The largest jurisdictions are showing the way by recognizing that the global nature of markets requires well thought-out cross-border arrangements ab initio when grappling with new regulatory challenges such as credit derivatives, non-bank financial institutions, or rapidly internationalizing stock exchanges. Regional regulators may be more reluctant to make the required leap, but in the long run it would be critical for the growth of the markets to do so. A corollary to this is the need to emphasize the practicalities of implementation from the outset of discussions on new regulatory or supervisory initiatives. The costs of leaving these considerations until later are too high to be acceptable.

For most regulatory issues, it will be necessary to live with existing national structures for a long time to come. Reliance on principles rather than detailed rules may allow for more consistent cross-border regimes along with local “cultural” differences. Informal understandings among regulators may often be as effective as formal ones, and may avoid the delays and complexities of international agreements. Principles-based cross-border regulation requires the intellectual flexibility to accept directionally congruent but not identical regulations. This is difficult for norm-driven regulators but essential if improvement of cross-border regulation is not to be held hostage to an impossible goal of perfect convergence.

- *Ex Ante and Ongoing Consultation with Industry.* Industry consultation on regulatory goals and proposals must explicitly cover the cross-border and home-host dimensions at the conceptualization, development, and implementation stages. International effectiveness and efficiency should be important “domestic” goals.

Home and host supervisors must make it a priority to avoid unintended differences, inconsistent and duplicative regulations, and rules that are not able to evolve with changes in industry practice. Meaningful cooperation and information exchange among supervisors and with groups must be institutionalized as a permanent, iterative process, giving equal priority to domestic and international issues.

Old models of regulation based on local entities and rules are inefficient and riskier than regulations that acknowledge group-wide risk management. Local regulatory traditions are in some instances compelling, but maximizing international consistency should now be a first priority where regulation of internationally active firms or international transactions is concerned. Consideration of international consistency, and whether a local issue truly needs to take precedence, should be a part of any regulatory decision.

- *Increased Reliance on Mutual Recognition.* The Guiding Principles set out clear objectives for the future direction of regulation. However, there are mechanisms to reduce the burden posed by existing regulation. Mutual recognition, even if based on informal sharing of tasks rather than formal delegation of responsibilities, should be the norm and not the exception. Where regulations in two or more jurisdictions achieve the same goal through different approaches, but are generally comparable, regulators should coordinate a determination of equivalence. It reduces resource burdens on both industry and the regulatory community to avoid duplicative requirements.

Stressing these fundamentals would enable regulators to produce new rules that better reflect the views of the international regulatory community and would be better aligned with industry practice. As AIG Chairman Nick Le Pan has said, unintended differences can be eliminated and any intended differences that remain should be clearly identified to be debated and, if necessary, managed by banks and regulators.

## HOW TO MOVE FORWARD

The Basel Committee has been a locus of international supervisory cooperation on banking issues and has traditionally welcomed input from the IIF. Its interest in

engaging with the Special Committee further argues for considering the Basel Committee as a natural counterpart for a focused dialogue on cross-border and home-host issues. Nevertheless, there is a strong feeling that such a dialogue should not focus on the specific issues addressed by the AIG, but on the broader orientation and strategic direction of the supervisory community in respect of these issues. As noted above, it would be desirable for securities and insurance supervisors to be included in such a dialogue. The internationalization of the world economy is such that all avenues should be explored to improve focus on the international dimension: many regulatory decisions now have significant cross-border implications, which might not have been the case even a few years ago. While the legal competencies and powers of local regulators will not be changed rapidly, special focus on international implications of domestic decisions, ways of heightening mutual recognition, and pragmatic solutions to legal problems can, as several instances already show, lead to much better international efficiency, even without legislative change.

- *Global Coordination.* One possibility could be to convene a small group of IIF representatives and senior regulators to consider the possible drafting of a mutual set of expectations that could guide relations among regulators and industry representatives from the world's top firms. It has also been suggested that greater reliance on colleges of supervisors beyond their current role in Basel II implementation would provide a constructive basis for greater coordination.
- *Mutual Trust and Respect for Judgment.* The mutual set of expectations developed by the small group would not have legal status but would provide an assumption for mutual trust among regulators and between regulators and the industry. More broadly, putting a high priority on the international dimension would encourage finding pragmatic solutions to cross-border issues, even when formal powers remain unchanged.

## ADDITIONAL DISCUSSION B:

### ANTI-MONEY LAUNDERING ISSUES

Anti-Money Laundering (AML) regulation developed because drug smugglers, organized crime, and corrupt political leaders need to convert their ill-gotten cash gains into easily transferable and investable assets. Terrorist organizations need to find ways to transmit funds to support their operatives.<sup>2</sup> AML regulation is different from other types of financial-services regulation. Unlike prudential regulation, it does not directly aim to reinforce institutions in order to assure the soundness of the financial system. Unlike consumer-protection regulation, it does not directly aim to assist individuals who cannot fend for themselves. Rather, it aims at containing the depredations of groups that threaten harm to society. It is of interest to law-enforcement authorities whose primary focus is outside the industry. Of course, AML regulations also have the direct benefit to financial institutions of addressing operational and reputational risks. Moreover, such regulations reinforce the soundness of the financial system by lessening the dangers of its abuse.

*Compliance Remains Difficult.* Financial institutions recognized early on that abuse of the financial system could not be allowed, and firms undertook major individual and collective efforts to understand and address the threat. The Wolfsberg Principles, sponsored by leading banks, set a global standard for know-your-customer (KYC) procedures. Global coordination is also well established, given that much money laundering is international in scope. The Financial Action Task Force (FATF) has contributed a relatively consistent global approach on difficult issues, albeit on a highly prescriptive basis to date. The recent dialogue by the FATF with industry on reviewing the guidelines with a view to delivering a more risk-based approach is a welcome step in the right direction.

Yet AML remains problematic because different wrongdoers use different means. And, by definition, wrongdoers try to make transactions look as ordinary as possible. Technological advances also make compliance difficult; they constantly alter the methods available both to money launderers and those trying to stop them. Moreover,

the rights of legitimate customers are unavoidably affected by AML regulation, especially with regard to privacy.

Firms necessarily take a risk-based approach to AML efforts. Not every transaction can be examined in the same way, and not every client can be given the same degree of due diligence. The issues of different institutions, products, and jurisdictions vary tremendously. There is no one template for a successful AML program, but the industry's (and regulators') sophistication continues to develop.

*High-Profile Issue.* With AML the classic regulatory problems are compounded by the social harms that it aims to stop, and the political premium on combating them. No one disputes the evils of drug smuggling or terrorism, but the shared aspiration of stamping out those evils is fundamentally no different from the other shared aspirations for efficient and effective regulation reflected in the *Proposal*.

If anything, the difficulty of AML issues makes it all the more important to apply the Guiding Principles.

Fostering mutual trust and respect for judgment, the foundation of the *Proposal*, is essential in a field when the smooth functioning of the financial system must be balanced against police goals. Except in rare cases where an employee is in league with money launderers, everyone is on the same side.

*Problems Firms Face.* Nevertheless, exceptionally confrontational regulatory patterns – with hair-trigger penalties – have developed because of the high profile of AML issues. Although the issue has been debated for over a decade, banks are still required to file vast numbers of currency transactions (CTRs in the US) and to make “suspicious activity reports” (differently designated by jurisdiction) on open-ended criteria. Banks have to examine clients' activities and histories against KYC standards that can be very exacting. Banks are expected to apply rigorous tests to correspondent banking, based on standards that may exceed what is realistically feasible. Thus, to reduce the likelihood of regulatory sanctions, banks are forced to adopt a very conservative approach to customer identification and reporting trans-

<sup>2</sup> The term “AML” here includes measures against terrorist financing.

actions, while at the same time being asked to avoid “defensive filings.” Moreover, despite efforts at global coordination, international groups still face too many duplicated but not fully consistent legal obligations, making compliance unnecessarily costly and difficult. Business that would be legitimate in home countries can be prevented by policies of countries tangentially affected by transactions, notably the US. Enforcement officials often seem to adopt a zero-tolerance attitude toward failure, even when examinations have previously found banks’ procedures to be sound, or when authorities have not provided guidance as to wrongdoers, or when failure to detect a KYC problem or report suspicious activity occurred despite good-faith efforts. Ex-post prosecutorial determination of the highest standards threatens disproportionate penalties and unexamined step-ups in regulatory expectations.<sup>3</sup> The eagerness to punish rather than correct problems has made firms shy away from making judgments, let alone embrace a principles-based approach.

*How to Improve the Picture.* It may be time to cut through the vast amount of discussion on this topic and restart the dialogue on an international, top-down basis. Given that AML has grown up very rapidly and under difficult circumstances, it should not be surprising that some review or rectification would be in order. The industry and the regulatory community arguably need a new conceptual reassessment of AML principles.

The UK and the Netherlands have made a good start, recognizing the limitations of rote AML reporting, but elsewhere massive amounts of reporting seem to be demanded by non-financial law-enforcement authorities who do not accept the application of firms’ risk-based judgment. It has been difficult to decide how to apply the concept of proportionality in an area where the stakes are high but the costs are borne by the industry. The value of much of the high-volume reporting required is open to question.

While financial regulators are also frustrated by these problems, AML is still far from being approached in a risk-based spirit of maximizing efficiency and effectiveness.

When Basel I was shown to be inadequate, the international community took up the difficult task of devising Basel II. Similarly, the effort on AML will not be easy, but international cooperation and consultation can foster reexamination of an AML system that now needs to be challenged for its effectiveness in achieving its goals and the costs and efficiency of the means to achieve them. Application of the Guiding Principles can help achieve a better result for all concerned.

## HOW TO MOVE FORWARD

The existing specialized international institutions, notably FATF and Wolfsberg, face a constant flood of specific issues and problems. It may be useful for a high-level public/private sector group with a broad, cross-sectoral view to undertake such a top-down discussion. Ideally the group would be composed of public sector participants from FATF, the regulatory community, and finance ministries, as well as appropriate high-level private-sector participants. Industry contributions could be marshaled by the Institute with representation not just of AML experts, but of international group leaders with the breadth to provide fresh perspectives.

Huge investments have already been made by firms to address AML compliance requirements. Regulators should bear in mind both the transitional and compliance costs firms would face should AML requirements change. More fundamentally, instead of continuing the growth of detailed rules driven by an enforcement mentality, it is time to explore a new approach based on trust between industry and regulators. In turn, this trust could afford industry more room to develop guidance for itself. For example, when revising its AML guidelines in 2005, the FSA gave weight to risk-based guidance developed by the Joint Money Laundering Steering Group on legal and regulatory obligations and on good practice.

The goal should be to resume the debate by focusing on facilitating risk-based management, defining a realistic confidence level for regulation, agreeing on means, and establishing transparency. Several of the Guiding Principles of the *Proposal* are implicated in this discussion:

<sup>3</sup>Of course, where an employee is involved in money laundering or where management is willfully negligent of clearly stated responsibilities, proportionate enforcement should be severe enforcement.

- *Mutual Trust and Respect for Judgment.* Many of the suggestions made in this paper will be better achieved if a process of developing awareness in industry is undertaken. This could in turn lead to the development of enhanced trust between industry and regulators.
- *Meaningful Legislative Dialogue.* Maintaining such a dialogue is necessary to focus on facilitating management of the AML problem on an ongoing basis.
- *Proportionate Enforcement.* As already stated, prosecutorial determination of the highest standards threatens disproportionate penalties and unexamined step-ups in regulatory expectations.

## ADDITIONAL DISCUSSION C:

### ENFORCEMENT ISSUES

A salient message of the *Proposal* is that certain enforcement actions can have disproportionate and unintended regulatory or economic consequences. Enforcement decisions can lead to “step change” in regulatory expectations that can undermine orderly supervision and penalize well intended and compliant firms.

*Predictable, Proportionate Enforcement.* Proportionate, fair, and tough enforcement against clear violations is necessary for effective regulation.<sup>4</sup> But enforcement should be the tool of regulation, not a substitute for it.

Enforcement decisions should include an assessment of how realistic it would have been for the institution to have anticipated the analysis asserted in an enforcement action. If enforcement would break new ground or change past interpretations, fairness and efficiency require that fact be taken into account in deciding whether to proceed with enforcement as opposed to other measures, and, at the least, in crafting remedies.

Furthermore, cognizance should be taken of the fact that the use of compulsory investigative powers can itself be punitive. Multiple, overlapping investigations by different national or sectoral authorities can be disruptive, and economic and fairness effects need consideration.

Similarly, long, drawn-out investigations sometimes lead to enforcement decisions years after the fact, perhaps after the people responsible for the issue have left the firm and the business has changed. Simple fairness requires that enforcement decisions be taken within a reasonable time after problems arise.

Sometimes, enforcement actions may include remediation measures applied to particular firms. The risk of future violation should, of course, be taken into account, but it is also important that the remediation be consistent with an overall regulatory strategy, not punishment in addition to fines or reprimands. Remedies should be designed to achieve clearly articulated goals, in consultation with the firm and in consideration of the firm’s risk

profile. Penalties should be reserved for willful egregious or irresponsible misconduct or substantial and negligent management failure. And, finally, in most cases there should be just one penalty for violation: Firms should not face a multitude of penalties for the same problem, especially if assessment of such penalties is spread over time.

*Enforcement and Regulatory Strategy.* Enforcement should be undertaken in concert with considered regulatory strategy. The secondary effects of enforcement actions on generally compliant firms need up-front consideration. Enforcement actions against bad actors are necessary in the interest of the entire industry. Generally, enforcement decisions should not constitute a de facto change in rules or interpretations of principles. If experience shows that a change of rules or interpretations is needed, its application to the rest of the industry should only come through normal procedures, including the opportunity to be consulted. The goal should be identified, the incentives to future behavior understood, and the alternatives of less-intrusive means to provide these incentives examined. If, in fact, a broadly applicable change proves to be necessary, time should be given to make necessary adaptations in an orderly manner.

Having said that, it should be made clear that the point of enforcement and the point of any MOU should be that regulatory considerations should drive the agenda and enforcement should be designed to enhance and support regulatory strategy. From a business point of view, a process driven by an enforcement agenda as opposed to regulatory strategy will rarely make sense.

*Necessity to Confront Problems.* How can the *Proposal* improve the way enforcement affects efficient and effective regulation? Part of the answer must be to urge regulators and firms in each jurisdiction not simply to accept the dysfunctional parts of current enforcement mechanisms. It is essential for firms and regulators not to shy away from such problems because of their difficulty.

Where enforcement decisions are in the hands of a ministry of justice or other agencies not specialized in

<sup>4</sup>In some countries, enforcement powers may not be adequately developed to meet the standards of the Basel Committee’s *Core Principles for Effective Banking Supervision* or other international standards. Such countries face an imperative task to develop effective enforcement in compliance with international standards. They need clarity of enforcement norms and rapid and sure consequences for wrong-doing, as well as sufficient means to assure fair and accurate enforcement. Such countries also have an opportunity to put in place truly efficient and effective means of enforcement that avoid some of the problems discussed in this paper.

financial services, there should be close consultation before any enforcement action is taken. An example given in the *Proposal* is the MOU between the US Justice Department and banking agencies on coordination before legal action against alleged AML violations. What is important is to require that enforcement decisions be taken with the benefit of the agencies' technical understanding and the opportunity to coordinate with regulatory strategy.

Even informal understandings as to consultative procedures, without the full mechanism of an MOU, would often help.

*Enforcement Based on Fundamentals.* The societal trend not only in the US but in the EU and elsewhere seems to be toward more formal litigation of legal texts, whereas the "principles-based" approach suggests a focus instead on economically effective resolution of problems.

*Compliance Based on Informal Discussion.* Confidential exercise of regulatory judgment promptly to correct regulated firms' difficulties is, or was, traditional in some countries, but may need reinforcement or updating. Particularly in the area of prudential regulation, it is often appropriate to recognize that publicity can be more damaging to the firm and to regulatory goals than either the challenged conduct or any formal reprimand. The good judgment of supervisors in such delicate situations deserves deference by industry and other public authorities alike. Consideration should be given to looking for ways to take the effective enforcement technique of informal consultation beyond the realm of prudential regulation and into other areas. Even where enforcement-led regulation has been the norm, a conversation between firms and regulators about reasonable expectations and compliance efforts could help preclude disruptive enforcement surprises.

To this end, firms should be given an incentive to engage in informal discussions without fear of retribution for undertaking internal investigations or raising issues in good faith with regulators. In some places, there is the danger that ameliorative efforts by firms may lead to trip-wire enforcement consequences, rather than to collaborative efforts to resolve problems.

"*Comply or explain*" fits well with the principles-based approach, but is only beginning to be understood and accepted outside the UK. *Risk-based* allocation of regulatory resources is still new to many agencies around the world, but is the most efficient and effective approach in many circumstances. Dialogue with regulators and enforcement authorities could focus on extending these simple concepts, which can be the key to more appropriate regulation.

Acceptance of "comply or explain" and "risk-based regulation" approaches presents cultural issues from both national and institutional perspectives. There may be specific hurdles to achieving their broad use in some places. For example, inducing firms to use "comply or explain" options may require litigation safe-harbors for good-faith actions. This is the kind of issue for which patient, but constant, dialogue can move the mountain.

*Litigation.* Private litigation triggered or conditioned by enforcement actions has long been a fact of life in the US, and this phenomenon may be spreading to European and other countries. No doubt private litigants may have legitimate claims related to grounds for enforcement. But the unpredictable nature of private litigation, especially where class actions are permitted, can turn what might have been proportionate correction of a problem into excessive penalizing of firms and bystanders and thereby distort risk management and business decisions. There is no easy solution, but, first, regulators should be asked to take litigation implications into account in deciding on enforcement responses. Alternatives such as "comply or explain" can be designed to minimize litigation openings, and legislative efforts can attempt to channel litigation back to redressing real economic harm to plaintiffs.

Dispute-resolution procedures for consumer complaints can redress errors or misunderstandings without cumbersome legal procedures or heavy penalties. But regulators and firms need to promote such alternative dispute resolution procedures.

*Enforcement Is No Longer a Purely Domestic Matter.* While enforcement of laws is fundamental to sovereignty, enforcement decisions can no longer be looked upon as purely domestic. It may be unclear where a violation

occurred; questioned actions may have taken place in many jurisdictions simultaneously or electronically; or the interests and policies of two or more jurisdictions may be affected by an enforcement decision.

Under these circumstances, the major financial markets should formalize and regularize consultation procedures as to whether, where, how, and on what theories enforcement actions in the international market should take place.<sup>5</sup> Such international enforcement actions should be consistent with coherent strategic views of how to resolve cross-border regulatory and enforcement issues. Within the EU, CESR and CEBS have begun this consultation, though more needs to be done. Outside the EU, IOSCO or the OECD can provide the framework for discussion, and mechanisms such as the EU/US financial services dialogue point the right way, though the actual mechanism may have to be bilateral MOUs for the foreseeable future. Informal consultation on enforcement against multi-jurisdictional problems can be useful, especially where the grounds for enforcement are unclear or the fact pattern against which the authorities want to proceed is novel. However, industry questions whether this approach is deep enough or consistent enough, and the goal should be to institutionalize and make mandatory enforcement-related consultation and, eventually, concertation of investigations and decisions.

Eventually, it should be possible to reach the situation whereby many if not most cross-border enforcement problems can be allocated to a “lead investigator” for resolution on mutual-recognition principles.

To some extent, international enforcement problems could be headed off if firms could submit international transactions or new products for coordinated “no-action” review ab initio, to avoid misunderstandings or clashes of interpretations later on.

IOSCO has taken some useful first steps toward coordination on financial fraud, but more global, private-sector involvement is indicated in efforts at coordination beyond private-sector involvement.

*Dialogue Needed.* Even where punitive approaches are enshrined in law, enforcement always entails judgment. An open dialogue on enforcement philosophy in each

jurisdiction, keeping in mind the principles of the *Proposal*, could bring enforcement into the realm of regulatory strategy.

At the very least, dialogue can enhance regulatory transparency as to enforcement policy. Clarity of expectations is critical to good compliance by well intended firms and to fairness of enforcement actions when necessary, as well as any related private litigation. Transparency can also help identify divergences between regulatory policy and regulatory strategy, isolating differing policy views of different authorities for reconsideration.

It is also necessary for firms, especially CEOs, to raise issues with regulators at an early stage, when issues first emerge. On the other hand, there is a need for regulators to improve high-level awareness of what they are doing to solve problems. This could be one means of avoiding incident-driven legislation by which regulators are sometimes trapped.

## HOW TO MOVE FORWARD

*Global Perspectives.* A globalized financial market and financial services industry will increasingly need regulatory enforcement that is consistent with an overall regulatory strategy in each jurisdiction, and that strategy (including its regulatory approach) will need to take account of and be coordinated with the global regulatory architecture of which each jurisdiction is a part. Enforcement means and philosophies should be broadly consistent across jurisdictions, and those countries that still have gaps in their enforcement capabilities as defined by the *Basel Core Principles* should be assisted by private and public sector actors alike to bring them up to global standards.

These are not easy issues, but they must be confronted. Old paradigms of “water’s edge” sovereignty will be neither fair nor effective in the narrow sense of punishing wrongdoers and will be inappropriate in the wider sense of advancing the goals of fair and open markets and competitive provision of services to clients. CESR has begun to confront these issues within the EU and within the securities sector, but greater attention needs to be paid to this issue in international fora.

<sup>5</sup> See, for an excellent overview of an actual case, Bradley J. Gans, “Enforcement Cooperation”, *International Financial Law Review*, October, 2006.

The IIF will look for opportunities to begin this dialogue, both in the US and internationally.

This paper elaborates on the IIF Guiding Principle of *proportionate enforcement*, but several of the other Guiding Principles of the IIF *Proposal* are also implicated:

- *Mutual Trust and Respect for Judgment*. Many of the suggestions made in this paper will be most meaningful if a greater degree of principles-based regulation can be introduced. Meanwhile, increased reliance on informal supervisory discussion or on concepts such as “comply or explain” reflect the principle of mutual trust and respect for judgment.
- *Collective Market-Based Solutions* can work in the enforcement area, whether through increased reliance on alternative dispute resolution or reliance on market sanctions in which “comply or explain” is applied.
- *Global Coordination*. No jurisdiction is isolated any longer and enforcement decisions in certain cases will require international coordination.
- *Meaningful Legislative Dialogue* will likely be necessary to achieve enforcement more focused on achieving economic goals than on following legal texts.

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