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## THE INTERNATIONAL REGULATION OF FINANCIAL CONGLOMERATES: A CASE-STUDY OF EQUIVALENCE AS AN APPROACH TO FINANCIAL INTEGRATION

JORGE E. VIÑUALES\*

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\* LL.M. in International Finance (Harvard), D.E.A. in International Law (IUHEI, Geneva), lic. iur (University of Fribourg). I am indebted to Professor Hal Scott of Harvard Law School for his comments and suggestions on an earlier version of this article. I remain exclusively responsible for any mistakes the piece may contain.

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INTRODUCTION

In December 2002, the European Union adopted the Financial Conglomerates Directive (Financial Conglomerates Directive or Directive),<sup>1</sup> which introduced a number of innovations to the overall regulatory framework applicable to large financial groups active in Europe. The main concern of the Directive is to ensure that operations at the group level are not conducted to the detriment of specifically regulated subsidiaries, such as banks, broker-dealers and insurance companies.<sup>2</sup> In doing so, the Directive potentially governs the activities of several foreign financial conglomerates not regulated by their host countries in a way deemed “equivalent” by the national implementing authority in Europe.<sup>3</sup> While the decision on the “equivalence” of a particular regulatory framework belongs to domestic regulatory agencies, the European Financial Conglomerates Committee and the Banking Advisory Committee have issued general guidance to

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1. Council Directive 2002/87, Financial Conglomerates Directive, 2002 O.J. (L 35) [hereinafter Financial Conglomerates Directive] of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate and amending Council Directives 73/239, art. 6, 1973 O.J. SPEC. ED (EEC), 79/267, art. 6, 1979 O.J. (EEC), 92/49 (EEC), 92/96, 1992 O.J. (EEC) and 93/22, art. 1(2) EEC, and Directives 98/78, art. 1(b)(c), 1998 O.J. and 2000/12, art. 1(1), 2000 O.J. (EC) of the European Parliament and of the Council.

2. *Id.*

3. In a recent speech given at a Conference in Brussels, Clive Briault, a Managing Director of Retail Markets at the British Financial Services Authority (FSA), pointed out: “[T]here are [fifteen] non-[European Economic Area] conglomerates with a European presence in which the FSA has a role to play. Indeed, the FSA is likely to be the Co-ordinating Supervisor for the majority of these.” Joint Level 3 Committees Conference (Nov. 24, 2005), *available at* [http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2005/24\\_cb.shtml](http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2005/24_cb.shtml).

help national authorities assess this point.<sup>4</sup> The U.S. and Swiss cases have, understandably, attracted special attention.<sup>5</sup> In both cases, however, the conclusions reached by the Committees raise difficult legal issues, particularly with respect to information exchange.<sup>6</sup> Although most concerned agencies have started a dialogue on the equivalence of regulatory frameworks, a clear understanding, including not only the legal but also the economic and political variables at stake, is of great importance for both regulators and financial groups.

Largely in response to the Financial Conglomerates Directive, the U.S. Securities and Exchange Commission (SEC) adopted a new regulatory framework providing American financial groups, which until then were not regulated at the group level, with a concrete way to avoid regulation by a European agency,<sup>7</sup> particularly the British Financial Services Authority (FSA).<sup>8</sup> This framework is two-fold. First, the SEC adopted a rule allowing broker-dealer holding companies to voluntarily register with the SEC as "Supervised Investment Bank Holding Companies" (SIBHC) under some conditions.<sup>9</sup> Second, the commission also adopted a rule, often referred to as the "Consolidated Supervised Entities" (CSEs) rule, tying voluntary submission to group-level supervision to an advantageous way of computing capital requirements for broker-dealers.<sup>10</sup> The Swiss authorities have also

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4. The only two general guidelines issued so far on this topic concern the United States and Switzerland: *EFCC/BAC General Guidance—USA Supervision*, COM (2004) final (July 6, 2004) [hereinafter *General Guidance USA*]; *EFCC/BAC General Guidance—Switzerland*, COM (2004) final (July 6, 2004) [hereinafter *General Guidance Switzerland*].

5. *General Guidance USA*, *supra* note 4; *General Guidance Switzerland*, *supra* note 4.

6. *General Guidance USA*, *supra* note 4, at 4; *General Guidance Switzerland*, *supra* note 4, at 3-4.

7. See SEC Final Rule: Supervised Investment Bank Holding Companies, 69 Fed. Reg. 34,472 (June 21, 2004); Alternative Net Capital Requirements for Broker-Dealers that Are Part of Consolidated Supervised Entities, 69 Fed. Reg. 34,428 (June 21, 2004).

8. See Hal S. Scott, *An Overview of International Finance: Law and Regulation*, in HANDBOOK OF INTERNATIONAL ECONOMIC LAW 33 (A.T. Guzman & A.O. Sykes eds., Edward Elgar Publishing, forthcoming 2006), available in preliminary form at [http://www.law.harvard.edu/programs/pifs/pdfs/international\\_finance\\_handbook.pdf](http://www.law.harvard.edu/programs/pifs/pdfs/international_finance_handbook.pdf).

9. See Supervised Investment Bank Holding Companies, 69 Fed. Reg. 34,472.

10. See Alternative Net Capital Requirements for Broker-Dealers that Are Part of Consolidated Supervised Entities, 69 Fed. Reg. 34,428.

taken similar steps, again, largely motivated by the need to satisfy the equivalence standards set forth by the Directive.<sup>11</sup>

These interactions between different jurisdictions offer an interesting set of facts with which to assess the performance of equivalence as a relevant approach to international financial integration, starting with the development of a transatlantic capital market. Equivalence is often conceived of as an alternative to harmonization.<sup>12</sup> Harmonization implies that two or more jurisdictions have come to apply similar standards.<sup>13</sup> Equivalence refers instead to the idea that two or more regimes are recognized as suitable for achieving similar regulatory objectives.<sup>14</sup> While from a conceptual standpoint there is a relatively clear difference between these two approaches, there is still some confusion as to how they relate to one another. One possibility would be to say that the two are mutually exclusive, but this does not warrant much support in practice. For instance, if one looks at the current E.U.-U.S. dialogue on international accounting standards, the equivalence approach is actually being used as a preliminary step towards harmonization.<sup>15</sup> However, this should not lead to the conclusion that

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11. Circulaire de la Commission fédérale des banques: Surveillance des grandes banques du 21 avril 2004 [hereinafter CFB 04/1] [Circular No. 04/1 of the Swiss Federal Banking Commission of April 21, 2004: Supervision of Large Banks], Apr. 21, 2004, (Switz.); Loi fédérale du 17 décembre 2004 sur la surveillance des entreprises d'assurance [hereinafter LSA], [Federal Statute on the Supervision of Insurance Undertakings], Dec. 17, 2004, Recueil systématique du droit fédéral [RS] 961.01 (Switz.) available at <http://www.admin.ch/f/rs> (adopted on December 17, 2004 and entered into force on January 1, 2006); Loi du 8 novembre 1934 sur les banques et les caisses d'épargne, [LB], [hereinafter FBA], Nov. 8 1934, RS 952, Art. 3b to 3h, as amended by LSA.

12. See Scott, *supra* note 8. There are many conceptual approaches to regulation. Hal Scott makes several distinctions. *Id.* First, he distinguishes between the regulation of firms (banks, insurance companies, broker-dealers, groups or conglomerates) and that of transactions (mostly cross-border securities offerings). *Id.* He then identifies seven different approaches to the regulation of financial transactions, and only three for the regulation of firms. *Id.* In this latter case, the alternatives are harmonization and equivalence (in two different forms: mutual recognition of home country rules; and conditional recognition of home country rules combined with self-protection measures). *Id.* Although his main focus is the regulation of cross-border branching by foreign banks, his discussion can be applied *mutatis mutandis* to the approaches to the regulation of international financial conglomerates. *Id.*

13. *Id.*

14. *Id.*

15. See HAL S. SCOTT, INTERNATIONAL FINANCE, TRANSACTIONS, POLICY,

equivalence is not viable as an independent approach. The purpose of this study is to explore the extent to which equivalence represents an approach on its own right.

Drawing upon recent developments in the international regulation of financial conglomerates, this article argues that, at least in some cases, equivalence is not only a practical alternative to harmonization, but it may also be a more effective one, for it takes into account the enforcement dimension and thus better serves the underlying goals of financial regulation. In particular, equivalence may better accommodate country specificities<sup>16</sup> as well as the potential conflicts between prudential objectives and considerations of competitiveness. By introducing some additional degrees of liberty in the way these two regulatory goals are reconciled in different jurisdictions, equivalence may avoid the rigidity inherent to harmonization, for which the level of enforcement remains the main adjustment mechanism. Of course, equivalence also entails significant challenges. Above all, one may wonder who should regulate a financial conglomerate. This question is relevant not only in cross-border regulation, but also within a system like the American system where several regulatory agencies (for financial groups, the Federal Reserve Board, the SEC, and state insurance regulators) may assert competence over the same entities. More generally, equivalence operates in a context strongly influenced by politics. Whether a particular regulatory regime is considered equivalent or whether further reform is needed may heavily depend upon the relative bargaining power of the agencies involved. It is therefore important, when dealing with the particular questions that will occupy the rest of this piece, to keep the political background in mind.

This article is structured into two main sections. The first section deals with the theoretical and historical rationales for regulating financial entities at the group level, as well as with the issue of enforcement structures. The basic idea is that equivalence may provide more lee-

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AND REGULATION, ch. 2 § D (12th ed. 2006).

16. See Howell E. Jackson, *Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications*, 12-14 (JOHN M. OLIN CTR. FOR LAW, ECON. & BUS., HARVARD LAW SCH., Discussion Paper No. 521, Aug. 2005). Jackson identifies six main types of country specificities that may hinder the effectiveness of regulations imported from foreign jurisdictions: differences in scale of the country; differences in composition and sophistication of the financial services industry; differences in regulatory objectives; different national endowments; different levels of enforcement intensity; and different levels of lawlessness of the population. *Id.*

way to domestic rule-makers for striking a balance that takes into account both conflicting policy goals and country specificities. These theoretical foundations provide the basis for a discussion, in the second section, of three concrete regulatory regimes of financial groups, namely those of the United States, the European Union and Switzerland. This article then analyzes how the equivalence approach is shaping the international regulation of financial groups, paying particular attention to the question of information exchange, which appears to be one of the main hurdles, not only for group-level regulation, but also, and more generally, for international regulatory cooperation as a whole.

## I. WHY ARE FINANCIAL GROUPS REGULATED?

### A. *General Remarks*

The activities of financial groups are regulated both at domestic and international levels. While there appears to be a consensus on the necessity of regulation, national authorities have only recently started to realize the importance of drawing an international level playing field. Twenty years ago, the then Governor of the Bank of England, Robin Leigh-Pemberton, acknowledged “on an international scale cooperation between securities regulators on matters such as capital adequacy and coordination between banking and securities supervisors [did] not exist to any useful extent.”<sup>17</sup> Less than a year ago, Commissioner Glassman from the SEC expressed the opposite view, that “[t]he U.S.-E.U. Dialogue has been very successful in establishing a cooperative forum in which concerns or regulatory conflicts can be raised and addressed early on so as to improve understanding and help smooth implementation of regulation for issuers and intermediaries operating on both sides of the Atlantic.”<sup>18</sup>

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17. Robin Leigh-Pemberton, Speech to the Group of Thirty Symposium on Equity Markets, London (Sept. 15, 1986), *cited in* Richard Dale, *International Financial Regulation*, in *THE AGE OF REGULATORY REFORM* 219 (Kenneth Button & Dennis Swann eds., 1989).

18. Cynthia A. Glassman, Commissioner, SEC, Remarks before the Center for the Study of International Business Law Breakfast Roundtable Series, (Oct. 7, 2005), *available at* [www.sec.gov/news/speech/spch100705cag.htm](http://www.sec.gov/news/speech/spch100705cag.htm) (last visited Nov. 21, 2006).

Why national authorities have been progressively led throughout the last two decades to fundamentally change the underlying basis upon which international banking and financial transactions are regulated is a question that can be approached from a variety of perspectives. In what follows, there are two issues of particular importance for the regulation of international financial conglomerates. The first concerns the underlying justifications for regulating these conglomerates, as well as the particular features of these groups that prevent conventional regulatory techniques, such as capital regulation, from being totally effective. The second refers to different structures that can be used to enforce the corresponding regulations. The very idea of international financial conglomeration, which involves activities transcending both sectorial and national boundaries, raises difficult questions as to who should be the regulator and how this regulator should operate. These two issues will be dealt with in separate sections. In a third section, the article will discuss how these issues arise in the context of the recent measures to regulate international financial groups. The main point of the overall discussion is to identify the type of problems that any attempt at regulating financial groups at the international level will need to address, and more specifically, to explore the strengths of equivalence in this context.

### *B. Rationales for Regulating International Financial Groups*

Regulation<sup>19</sup> in the banking and financial sectors is based mainly on two broad and closely related considerations: managing risk while ensuring competition.<sup>20</sup> Concerning the first, a distinction is usually drawn between the risks for depositors/investors<sup>21</sup> and those for the

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19. The academic literature on “regulation” developed from the 1970s onward, focusing principally on a variety of “market failures” most often related to issues of competition and distribution. For a useful overview of the foundational literature dealing with regulation from the economic, legal, and political science perspectives see the classic work of DANIEL F. SPULBER, *REGULATION AND MARKETS*, 21-69 (1989).

20. There are, of course, some other justifications that could be advanced, such as redistributive policies or paternalistic arguments. However, risk-management and competition are the two most relevant, at least for the purposes of analyzing the foundations of group-level regulation.

21. In a classic article published in the *Yale Law Journal*, Robert Clark identifies five possible reasons for granting special protection to “suppliers of capital.” Robert C. Clark, *The Soundness of Financial Intermediaries*, 86 *YALE L.J.* 1, 12-22 (1976). First, Clark points to a number of empirical studies suggesting that it may

economy as a whole,<sup>22</sup> the basic point being that actions that may harm depositors or investors do not necessarily threaten the whole economy.<sup>23</sup> As to the competition rationale, risk-regulation clearly impacts the strategies available to financial intermediaries to compete in the market, which in turn fosters regulatory arbitrage either across sectors<sup>24</sup> or across domestic/national boundaries. Thus, the purpose of regulation is not only to avoid monopolies, but also to establish a level playing field for financial intermediaries subject to different regula-

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be easier for insiders to steal from financial intermediaries than from ordinary corporations. *Id.* at 12-13. Second, absent regulation, financial intermediaries could change their level of risk much faster than what a regular corporation could do, making depositors/investors bear the cost of the increased risk. *Id.* at 14-15. Clark argues, in particular, that financial institutions are especially prone to excessive risk-taking. *Id.* at 15-18. Third, the costs of information regarding the risks involved with alternative investments in financial intermediaries may be too high for some depositors/investors to place their funds efficiently. *Id.* Fourth, and in a similar vein, fund suppliers may simply be unable to make economically wise choices when allocating their funds. *Id.* at 18-21. Finally, small investors may require more comprehensive protection than wealthier or more sophisticated ones, given their relatively larger dependence upon the funds deposited/invested for their everyday life. *Id.* at 21-22. Clark himself did not take these arguments for granted. *See generally id.* They are still recurrent enough in the literature not to be neglected. This is particularly the case for the securities industry, where the emphasis is not so much on the potential dangers that may derive from the failure of broker-dealers but rather on the need for investors to be protected against fraudulent practices.

22. *See id.* at 10-11.

23. Beyond the protection of a particular group of the population, the critical role of financial intermediation for the functioning of the economy as a whole provides an additional argument for regulating the activities of intermediaries. *See* HOWELL E. JACKSON & EDWARD SYMONS, REGULATION OF FINANCIAL INSTITUTIONS 7 (1989). This is usually referred to as the “systemic risk” rationale for regulation. *Id.* The idea is that, aside from the social losses a bank failure would cause, such as the cost for either the deposit insurance fund or the state welfare system, a disruption in financial intermediation would entail “systemic costs,” such as “irrational bank runs . . . problems in clearing systems, disruption of capital underwriting, and unexpected contractions of the money supply.” *Id.*

24. Generally speaking, the literature in the United States has distinguished four specific sectors: depository institutions, insurance companies, broker-dealers, and investment companies and their advisers. Other jurisdictions have different categories, particularly in those countries where banks have traditionally been allowed to be fully engaged in underwriting and dealing in securities. But let us leave aside, for the time being, this complexity and focus simply on the existence of a number of specific sectors. These sectors are characterized by the fact that a single common regulatory approach would govern their operations.



tory frameworks to compete fairly.<sup>25</sup> One point that is critical to this analysis is that these two main rationales may, under some circumstances, conflict with one another. Indeed, a level playing field can be created either by introducing additional regulation or by removing part of the existing one. However, insofar as the existing regulation tends to ensure a given prudential threshold, removal may not be an easy option, for it may jeopardize the overall financial system. Conversely, a stringent regulatory framework may impair the competitiveness of those financial intermediaries subject to it. This point must be kept in mind when discussing the specific rationales for which financial conglomerates require particular forms of regulation. Overall, the same two major rationales apply, but with important adjustments reflecting the structure and activities of these entities.

This article first focuses on *prudential considerations*. In an important article written in 1994, Howell Jackson retraces the trend towards enhanced obligations imposed on financial groups.<sup>26</sup> Jackson identifies two main justifications that have been advanced in practice to legitimize enhanced obligations on groups.<sup>27</sup> First, holding companies would be particularly prone to prey on their controlled subsidiaries, thus increasing the level of risk of controlled intermediaries.<sup>28</sup> Jackson calls this the “hungry wolf” hypothesis.<sup>29</sup> From the doctrinal point of view, this rationale is implicit in the well-known “source-of-strength” doctrine, which holds that parent companies should represent a source of financial and managerial strength for their subsidiaries.<sup>30</sup> Second, according to what Jackson refers to as the “regulatory

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25. See generally SPULBER, *supra* note 19.

26. Howell E. Jackson, *The Expanding Obligations of Financial Holding Companies*, 107 HARV. L. REV. 509 (1994) [hereinafter Jackson, *Expanding Obligations*]. The piece does not deal with investment bank holding companies, for they were not regulated at the time. See also Howell E. Jackson, *Regulation of a Multisector Financial Services Industry: An Exploratory Essay*, 77 WASH. U. L.Q. 319 (1999).

27. Jackson, *Expanding obligations*, *supra* note 26, at 512.

28. *Id.*

29. *Id.*

30. According to the Board of Governors of the Federal Reserve Board, the main regulator of financial holding companies, in the absence of this doctrine there would be “an incentive for holding companies to maximize the short-term, cyclical profits of their subsidiary banks, regardless of risk, because the bank insurance fund—not the parent holding companies – would ultimately bear the costs if the subsidiaries later failed.” Petition for Certiorari at 17, Board of Governors v. Mcorp., 502 U.S. 32 (1991) (Nos. 90-913 & 90-914), cited in Jackson, *The Expanding*

deterioration” hypothesis, group-level regulation would help fill the regulatory gaps in traditional forms of regulation, making the holding company responsible for excessive risk-taking by its subsidiaries.<sup>31</sup> In other words, regulation at the group level would help harness moral hazard at the subsidiary level.<sup>32</sup> Jackson has recently taken up these ideas refining them in a chapter dealing with group-level regulation from the specific perspective of capital requirements.<sup>33</sup> Capital requirements, which constitute probably the main technique for the prudential regulation of groups, are not easily applied to financial conglomerates.<sup>34</sup> The specific features of financial conglomeration would make the need for capital regulation ambiguous. In this respect, Jackson discusses the various technical weaknesses of entity-level capital

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*ing Obligations of Financial Holding Companies*, *supra* note 26, at 562 n.194. Jackson concludes that the “hungry wolf” hypothesis is unwarranted. *Id.* at 566-67. He reviews two sets of studies. The first only supports the idea that the portfolios of affiliated institutions tend to differ considerably from those of unaffiliated ones. *Id.* at 573-74. The second set is far more conclusive. It asks whether affiliation with a holding company is related with bank failures. The findings suggest that affiliation is negatively correlated with bank insolvency. *Id.* at 574-76. As to the “regulatory deterioration” hypothesis, see Jackson, *Expanding obligations*, *supra* note 26. Jackson’s conclusions are mostly based on a previous study he conducted on the performance of 175 thrifts. This study suggests that the impact of group regulation on the thrift industry is positively correlated with the operational performance of affiliated thrifts. *See id.* at 573, 577. A recent staff report of the Federal Reserve Bank of New York points in the same direction. ALLEN B. ASHCRAFT, ARE BANK HOLDING COMPANIES A SOURCE OF STRENGTH TO THEIR BANKING AFFILIATES? (Federal Reserve Bank of New York Staff Reports, no. 189) (June 2004). Using data on the financial condition of insured commercial banks between 1986 and 1999, the study finds that banks affiliated with multi-bank holding companies are significantly safer than non-affiliated ones. *Id.* Moreover, and this is important for purposes of reconciling this study with those cited by Jackson, the analysis suggests that the positive effect of affiliation was not clearly present before 1989, when the Financial Institutions Reform Recovery and Enforcement Act (FIRREA) was passed. *See id.*

31. Jackson, *Expanding obligations*, *supra* note 26.

32. Jackson points also to politics as an additional rationale that explains enhanced group regulation: “The government has gone after holding companies for the same reason that bank robbers go after banks—that’s where the money is . . . . The alternative – passing the costs along either to taxpayers or to public claimants on financial institutions, such as depositors or pensioners—has obvious and significant political costs.” *Id.* at 559.

33. Howell E. Jackson, *Consolidated Capital Regulation for Financial Conglomerates*, in *CAPITAL ADEQUACY BEYOND BASEL: BANKING, SECURITIES AND INSURANCE* 123-45 (Hal S. Scott ed., 2005).

34. *See id.*

regulation,<sup>35</sup> the unique risks associated with financial conglomerates,<sup>36</sup> the diversification benefits associated with financial conglomerations,<sup>37</sup> and internal risk management techniques.<sup>38</sup> Admittedly, as

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35. *See id.* at 125-26. Three main weaknesses are identified. First is the issue of “excessive leverage.” *Id.* A holding company may finance the capital of its regulated subsidiaries by issuing bonds and then, in times of financial stress, withdraw this capital or force its subsidiaries to make uneconomical moves. *Id.* Second is the “double or multiple gearing” practice by which a holding company uses the same assets to meet both its own capital requirements and those of its subsidiaries. *Id.* Third, unregulated affiliates may pose a particular threat to the overall group, a risk which is not covered by a corresponding increase in the capital held by the group. *Id.* These issues could be subsumed under what Jackson calls, in his other contribution, the “hungry wolf” hypothesis. *See* Jackson, *supra* note 26. This hypothesis would favor more capital requirements.

36. Here, Jackson points to the greater systemic risk created by the size and complexity of some financial conglomerates to the reputational risk these groups undergo if one subsidiary falls in disgrace as well as the already mentioned “hungry wolf” argument, according to which financial conglomerates are more prone to exploit their subsidiaries. *See* Jackson, *supra* note 33, at 126-27. This hypothesis would also favor more capital requirements.

37. Jackson cites a study according to which the optimal level of capital necessary to support a diversified group at a given level of insolvency is lower than the one required at this same level of insolvency to support a stand-alone entity. *See* Andrew Kuritzkes, Til Schuermann, Scott Weiner, *Risk Measurement, Risk Management, and Capital Adequacy in Financial Conglomerates*, in BROOKINGS-WHARTON PAPERS ON FINANCIAL SERVICES 141-93 (Robert Litan & Richard Herring eds., 2003), *cited in* Jackson, *supra* note 32, at 127. This would stand for lower capital requirements. Several studies focusing on the effects of restricting the diversification of bank activities suggest that such restrictions tend to yield negative results, particularly regarding banking-sector efficiency or even the probability of banking crises. *See* James R. Barth, Gerard Caprio Jr., and Ross Levine, *Banking Systems around the Globe: Do Regulations and Ownership Affect Performance and Stability?*, in PRUDENTIAL SUPERVISION: WHAT WORKS AND WHAT DOESN'T 31-88 (Frederic Mishkin eds., 2001) and the studies cited therein. A more recent study expands and refines this conclusion finding that restrictions on diversification are negatively related to bank development and positively related to the likelihood of crises. *See* James R. Barth, Gerard Caprio Jr., and Ross Levine, *Bank Regulation and Supervision: What Works Best?*, 13 J. FIN. INTERMEDIATION, 205-48 (2004).

38. In practice, indeed, the top managers of financial groups are deeply concerned with the overall risk profile of the group and usually implement detailed risk management systems affecting the whole economic entity of the group. The conclusions to be derived from this as to whether higher or lower capital requirements are desirable are ambiguous. As Hal Scott points out:

[f]irms determining economic capital—only on a consolidated basis—implicitly assume that there are no organizational boundaries between firm

Jackson points out, “[e]xperts may differ over the importance of the various justifications for consolidated capital oversight, but collectively the arguments in favor of extending capital oversight to financial conglomerates present a compelling case for some sort of consolidated capital supervision.”<sup>39</sup> This conclusion does not necessarily take into account that, as discussed before, increased capital requirements also represent a competitive disadvantage for internationally active groups. This leads to the second major rationale for regulating financial conglomerates.

Considerations of *competitiveness* also present some ambiguities when it comes to deciding whether they stand for more or less regulation. The competition rationale has two dimensions. The first dimension is concerned with preventing the development of anti-competitive practices. As one competent observer noted several years ago, “[f]inancial holding company systems . . . may be formed to accomplish or facilitate anticompetitive practices, such as tie-ins, reciprocal dealing, predatory pricing, and the elimination of potential competition.”<sup>40</sup> In practice, however, the need for stricter standards in the financial area has yet to be demonstrated.<sup>41</sup> Moreover, even if this need

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units; it is all for one and one for all. Regulators would never permit this because, in effect, it requires cross-guarantees among all the units in the banking organization. Bank regulators would not permit the bank to extend such guarantees.

See CAPITAL ADEQUACY BEYOND BASEL, *supra* note 33, at 11.

39. See Jackson, *supra* note 33, at 128.

40. Robert Charles Clark, *The Regulation of Financial Holding Companies*, 92 HARV. L. REV. 789, 826 (1979).

41. *Id.* at 836. In this regard, a recent report of the Group of Ten provides some evidence regarding the anticompetitive effects of consolidation in the financial sector. See Group of Ten, *Report on Consolidation in the Financial Sector*, January 2001, available at [www.bis.org/publ/gten05.pdf](http://www.bis.org/publ/gten05.pdf) [hereinafter Report on Consolidation in the Financial Center]. As far as retail banking is concerned, higher concentration tends to lead to less favorable conditions for small business loans, retail deposits, and payment services. *Id.* A first set of studies compares markets with different degrees of concentration at a given point in time. *Id.* at 271-72. The report also mentions that this evidence is less strong for studies based on 1990s data, and that, in at least one case, increased competition has not been offset by the higher concentration. *Id.* A second set of studies, focusing on the markets that have experienced consolidation, confirms the idea that this phenomenon affects prices. *Id.* The anticompetitive effect is also noticeable in the investment bank industry, although there are very few studies on this issue. *Id.* at 272-73; see also Hsuan-Chi Chen & Jay R. Ritter, *The Seven Percent Solution*, 55 J.FIN. 1105 (2000). However, this evidence is not in itself enough to justify stricter antitrust standards.

could be empirically established, the relation between financial stability and antitrust would still remain ambiguous, as too much competition may lead disadvantaged companies to adopt increasingly risky strategies.<sup>42</sup> Thus, too much competition may be as bad as too little. In this context, regulation would appear as a tool to strike a satisfactory balance between two undesirable extremes. The question is how much regulation? Adding to the ambiguities so far reviewed, the second dimension of the competition argument further suggests that too much regulation may not only be bad for prudential purposes but also for the international competitiveness of national companies. This article has already referred to the possible tension between prudential and competitiveness questions. This tension is particularly acute at the international level in which financial groups operate.<sup>43</sup> As a matter of fact, the competition rationale may lead to opposite conclusions according to whether it is viewed from the domestic or the international perspective. Many examples of this can be given. For instance, at least one scholar has argued that the adoption of the Foreign Bank Supervision Enhancement Act of 1991 (FBSEA), which introduced new limitations on foreign bank state-chartered branches, did not only seek to enhance prudential standards but also had the purpose of establishing a level playing field with federal branches.<sup>44</sup> Perhaps the most well-known illustration of this issue is the U.S. claim that Japanese banks had a competitive advantage over U.S.-regulated banks because of the lower capital requirements prevailing in Japan.<sup>45</sup> As demonstrated later, the SIBHC and CSE frameworks can also be seen as graduated responses to circumstances in which prudential and competitiveness considerations point in different directions.

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42. The Group of Ten report notes:

For the financial sector there might be instances in which competition may have a negative impact on stability, as the least efficient firms may have an incentive to increase their risk in order to reach the industry profitability level (the so-called incentive to "gamble for resurrection"). If these firms are large, financial stability may be threatened.

*Report on Consolidation in the Financial Sector*, *supra* note 41, at 267 and generally ch. 3.

43. See SCOTT, *INTERNATIONAL FINANCE*, *supra* note 15, ch. 3, § C.2.f.

44. *Id.*

45. See Dale, *supra* note 17, at 218-19. This was one of the major drivers leading to the adoption of the Basel I capital standards in July 1988. *Id.* However, as discussed later, the development of a level playing field may require more than mere harmonization of regulatory standards.

The preceding remarks are intended to show how ambiguous the rationales underlying the regulation of international financial conglomerates may be. In this context, the possibility to tailor the regulatory approach to the specific conditions in a given country would represent an advantage.<sup>46</sup> This possibility provides one argument in favor of equivalence as an overall approach to international financial integration. Indeed, while a harmonized set of standards would leave little room for adjustment to country and policy specificities, different but equivalent strategies would leave more room to maneuver. Moreover, as demonstrated in the next section, the little leeway left by a harmonized set of standards may lead to “covert adjustment” practices, particularly those which may lower the level of enforcement to favor home country firms.

### *C. Enforcement Structures*

The issue discussed in this section counters one of the usual assumptions of the efforts towards the harmonization of international regulatory standards, namely that similar rules produce similar effects.

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46. A wide range of different techniques can and have been used over time to attain substantially similar goals. A hypothetical list of the most traditional ones would include, among others: initial and subsequent capital requirements; licensing procedures for entry, limitation on the line of business and geographical expansion; regulation of product prices; imposition of special fiduciary duties; subjection to various forms of examinations; reporting requirements; restraints on the use and valuation of assets; restraints on the nature, amount, and valuation of liabilities; liquidity reserves; deposit or account insurance; special conflict of interest rules; depositor preference provisions; special insolvency procedures; and many others. See Clark, *supra* note 21, at 10 n.36. More recently, practitioners and analysts have emphasized the potential of “market disciplines” as an efficient way of monitoring financial institutions in countries with well developed financial markets. The term “market disciplines” usually refers to the incentives for sound risk practices imposed on financial intermediaries by investors, particularly through an increase in the cost of funding, access to liquidity, and market perception. For a discussion on this issue see Geof Mortlock, *Strengthening Market Disciplines in the Financial Sector*, 65 No. 3 RESERVE BANK OF NEW ZEALAND BULLETIN 38-55 (2002); Hal S. Scott, *Market Discipline for Financial Institutions and Sovereigns*, in MARKET DISCIPLINE ACROSS COUNTRIES AND INDUSTRIES 69, 69-77 (Claudio Borio et al. eds., 2004). For a concrete initiative, see the detailed proposal for optimal bank capital regulation issued by the U.S. Shadow Financial Regulatory Committee on March 2, 2000 calling for increased reliance on subordinated debt as a regulatory tool. STAFF OF THE U.S. SHADOW FIN. REGULATION COMM, REFORMING BANK CAPITAL REGULATION (2000).

Among the many reasons why such an assumption seems inaccurate is the fact that similar rules may be unevenly enforced by different regulatory agencies. Neglecting the enforcement stage<sup>47</sup> of rule implementation may jeopardize not only the establishment of an international level playing field<sup>48</sup> but also the pursuit of a minimum prudential level.<sup>49</sup> The divergence in enforcement levels gives particular importance to the question of who should be the supervisor of an international financial conglomerate or, in other words, what is the best enforcement structure.

From a conceptual perspective, one can organize the different types of enforcement structures along two axes. The first axis concerns the subject-matter of the regulation and goes from an integrated regulatory structure to a functionally separated one. The second axis focuses instead on the number of regulators intervening and goes from

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47. The expression "enforcement stage" is intended to cover not only formal steps, such as the transposition of directives in the European Framework or the implementation of international standards by domestic legislation, but also informal practices that give teeth to black letter law. This latter point has seldom been addressed officially, perhaps because casting doubt on the will of foreign regulators to actually apply standards is politically sensitive. For a study of enforcement levels see Jackson, *supra* note 16, at 14-29.

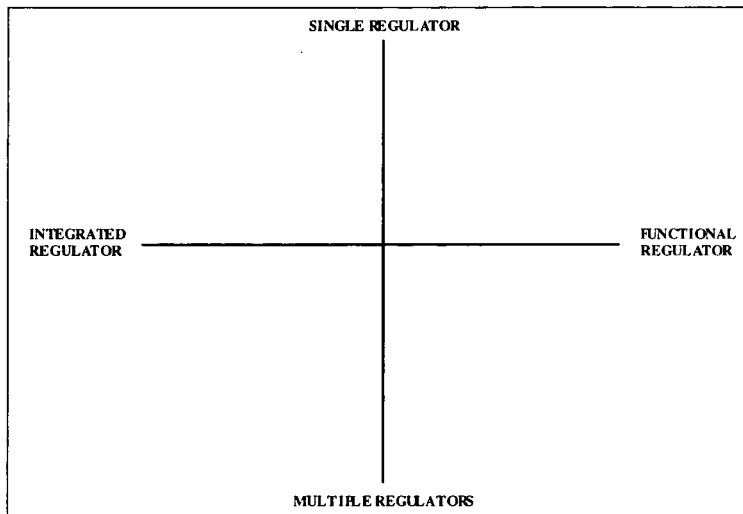
48. This is, in fact, probably the major problem affecting international standard setting. As Mario Giovanoli, the former General Counsel of the Bank for International Settlement, put it: "The questions arising in connection with the implementation of international soft law standards within domestic jurisdictions and at the international level clearly show that this issue is the Achilles' heel of such standards." Mario Giovanoli, *A New Architecture for the Global Financial Market: Legal Aspects of International Financial Standards*, in *INTERNATIONAL MONETARY LAW ISSUES FOR THE NEW MILLENIUM* 45, 45 (Mario Giovanioli ed., Oxford University Press 2000). International regulatory harmonization is the most common approach to the development of an international level playing field for competition. However, this does not mean that, through harmonizing some regulatory requirements, the competition-related problems affecting groups subject to different frameworks are automatically solved. See Hal S. Scott & Shinsaku Iwahara, *In Search of a Level Playing Field: The Implementation of the Basel Capital Accord in Japan and the United States*, GROUP OF THIRTY OCCASIONAL PAPER, no. 46 (1994).

49. One of the components of the Barings failure in 1995, according to a report of the U.K. House of Commons Treasury Committee, was that the Bank of England, Barings' lead supervisor, served as supervisor and promoter of London as a financial center at the same time. The report of the Bank of England on this crisis acknowledged that some "informal concessions" had been made to Barings in the form of not enforcing a lending limits rule. See SCOTT, *supra* note 15, ch. 14 § E.4. Similar claims have been made regarding the poor supervision of banks that led Japan to the so-called "lost decade."

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a single regulator structure to one characterized by the coexistence of multiple regulatory agencies. Although the idea of a single regulator may seem similar to that of an integrated one, the two are distinct. A single regulator may have jurisdiction over only a specific functional area, while an integrated regulator may participate in a collegial structure overseeing an internationally active financial conglomerate. The four theoretical extremes can thus be represented as follows:

## EXHIBIT 1



One could use these two axes to conceptually map the different institutional alternatives. For instance, looking exclusively at the United Kingdom, the FSA would operate as both a single and an integrated regulator, thus being located at the upper-left corner. However, considered from the European perspective, the FSA would be only one of the regulators involved in the oversight of a financial conglomerate,<sup>50</sup> thus belonging to the lower-left quadrant. Conversely, the U.S. banking regulatory structure, which is characterized by the coexistence of several functional regulators such as the Comptroller of the

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50. The framework of reference does not need to be the European Union. For instance, the Hong Kong Shanghai Bank Corporation (HSBC) is overseen by a college of regulators headed by the FSA, also including regulators from the United States, France, Switzerland, Canada and Hong Kong. *See generally* SCOTT, *supra* note 15, ch. 2.



Currency, the Federal Reserve Board, the FDIC and state authorities, would be located in the lower-right quadrant. The Federal Reserve Board alone, as the single functional regulator of bank holding companies, would be placed at the upper-right quadrant. Beyond these relatively clear-cut illustrations one may also encounter more hybrid forms such as “coordinators,”<sup>51</sup> “lead supervisors,”<sup>52</sup> or “collegial supervisors,”<sup>53</sup> all involving some degree of collegiality and/or functionality.

There has been considerable controversy as to what is the most suitable enforcement structure for international financial conglomerates. There are many possible alternatives. One author, for instance, has argued that harmonization should eventually lead to the establishment of a single regulator responsible for the international enforcement of a given set of standards.<sup>54</sup> While this alternative remains theoretically possible in the distant future, in the short to medium terms country specificities as well as the still very strong national susceptibilities make such an alternative extremely difficult. If, instead of harmonization, equivalence is used as the underlying approach towards integration, one would expect to have some form of collegial regulatory structure heavily dependent upon international cooperation. Broadly speaking, regulators seem to favor this latter enforcement structure, although they recognize it may be more easily proposed than implemented. In this regard, Sir Callum McCarthy, the head of the British FSA, has warned against the many complexities that are left in the dark by proponents of the “lead supervisor” model.<sup>55</sup> McCarthy gives two main reasons why this model is problematic. First, he points to the fact that the regulator of the parent company may be unwilling or unable to supervise the worldwide activities of

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51. This modality has been introduced by the Financial Conglomerates Directive, as we will see later on.

52. See European Financial Services Roundtable, *On the Lead Supervisor Model and the Future of Financial Supervision in the E.U.* (June 2005), available at <http://www.efr.be/members/upload/news/22676EFR1svfinal-June2005.pdf> (last visited Nov. 25, 2006).

53. One example of a collegial supervisor was that established to oversee (unsuccessfully) the Bank of Credit and Commerce International (BCCI). See *infra* note 57.

54. See SCOTT, *supra* note 15.

55. Sir Callum McCarthy, Chairman, Financial Services Authority, *How Should International Financial Service Companies Be Regulated?* (Sept. 22, 2004), available at <http://www.fsa.gov.uk/Pages/Library/Communication/Speeches/2004/SP196.shtml> (last visited Nov. 25, 2006).

the group.<sup>56</sup> The usual example in this respect is the Bank of Credit and Commerce International (BCCI) case, where the Luxembourg supervisor had, indeed, been unable to detect the manipulations through which BCCI had artificially been perceived as solvent.<sup>57</sup> Second, a single regulator can hardly be aware of the specific features and needs of foreign jurisdictions.<sup>58</sup> The alternative model advanced by McCarthy would consist of some sort of “college of regulators” in which the lead would not pertain to the parent company’s home regulator but rather to the supervisory authority where the group has its main activities.<sup>59</sup> The “lead supervisor” model remains, nevertheless, an attractive alternative to the eyes of other observers and policy makers, at least within the European space.

The two ideas, namely that of a “lead supervisor” and that of “college of supervisors,” are not entirely incompatible. In fact, their main difference concerns the question of who should lead the college and the extent to which the leader’s view should prevail. As a recent policy paper put it:

[T]he establishment of the lead supervisor would be complemented by the setting-up of a so-called “college of supervisors,” which, in normal circumstances, would include at a minimum representatives of the supervisory authorities of those countries where the institution has substantial operations; however, to the extent an E.U. supervisor does not want to participate in the college of supervisors,

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56. *Id.* paras. 11-12.

57. See SCOTT, *supra* note 15; see also Hal S. Scott, *Supervision of International Banking Post-BCCI*, 8 GA. ST. U. L. REV. 487, 487-509 (1992). BCCI, an unregulated holding company based in Luxembourg, was the parent of two banks, one incorporated in Luxembourg and the other in the Cayman Islands. *Id.* at 492. Each of these two banks had subsidiaries, branches, and agencies in sixty-nine countries, and their principal operations were outside of their nominal home countries. *Id.* The failure of BCCI led both international bodies and national supervisors to strengthen the regulatory framework applicable to international financial groups. *Id.* at 500. Some of the principles already present in the Basel Concordat were upgraded to the level of minimum standards. *Id.*

58. It is helpful to recall here the type of specificities inventoried by Jackson, such as differences in scale or size of the country, differences in composition and sophistication of the financial services industry, differences in regulatory objectives, different national endowments, different levels of enforcement intensity, and different levels of lawlessness of population. See Jackson, *supra* note 16, at 12-14.

59. See McCarthy, *supra* note 55, para. 21.

such supervisor would not be exonerated from implementing the decisions of the E.U. lead supervisor.<sup>60</sup>

More importantly:

In a crisis situation, the college of supervisor [sic] would need to change in character. Whatever structure is chosen for the college in times of crisis . . . the lead supervisor would continue to have a special role amongst supervisors, in particular as regards the coordination of the crisis management efforts . . . [and] a core of the college would become a management team for the group of supervisory authorities . . . .<sup>61</sup>

These different alternatives are interesting insofar as they illustrate the ambiguous relationship between standards and enforcement as well as the underlying issue of mutual trust among countries. Trust is indeed important for both harmonization and equivalence. In his aforementioned speech, Sir Callum McCarthy pointed to “the fraternity of central bankers and regulators . . . the mutual trust, shared vision, confidence and consciousness of mutual dependence—as well as of conflicts of interest—which exists [sic] among central bankers and, where they are different, financial supervisors.”<sup>62</sup> While such trust may indeed exist, it does not embrace every single regulator of the world, and, as this article will discuss next, even among brothers trust is limited.

#### D. Mapping Ambiguities

The preceding discussion provides the theoretical background necessary for an examination of how the issues reviewed arise in the context of the recent developments in the regulation of international financial conglomerates.

One should note that, in this area, prudential requirements and considerations of competitiveness often point in different directions. On the one hand, one could expect that the increasingly international activities of financial groups translate into more competition within domestic markets. Moreover, the more a regulatory framework seems favorable to foreign banks, the more these banks will tend to come under its jurisdiction. Thus, at least at the theoretical level, there should be some deregulation. However, things may be different in

60. European Financial Services Roundtable, *supra* note 52, para. 25.

61. *Id.* para. 29.

62. *See* McCarthy, *supra* note 55, para. 7.

practice. Two main arguments suggest that considerations of competitiveness may in fact have the opposite effect.<sup>63</sup> First, prudential considerations may impose limits on deregulation. Second, as risk considerations set the bottom line for the activities of financial groups, prudential regulation may translate into a competitive disadvantage for financial groups based in more demanding jurisdictions, as opposed to groups subject to more liberal regimes. This article has already mentioned how the Basel capital standards were largely nurtured by the U.S. attempt to subject Japanese banks to similar capital requirements as those imposed on U.S. banks.<sup>64</sup>

However, harmonizing standards may not be enough to establish a level playing field. As mentioned before, it has been argued that much more than the mere harmonization of capital standards is needed to actually eliminate competitive disparities.<sup>65</sup> Such disparities will remain unless many other issues are also addressed, such as accounting and tax rules, government support, rules on activities restrictions, and above all, that the most concerned regulators commit themselves to a comparable level of enforcement.<sup>66</sup> And even if a similar level of enforcement was achievable, it would not always be desirable from a competitive perspective. Regulators may well seek to foster the international competitiveness of their national groups by being more “tolerant” with them. This would risk introducing a sort of covert competition policy, all the more insidious that standards would be formally the same. This is precisely the type of scenario where equivalence may be an interesting alternative.

The emerging regulation of non-bank financial conglomerates offers a good illustration of why this may be so. Traditionally, the banking and securities businesses were separated in the United States and Japan.<sup>67</sup> Until very recently, only holding *companies* possessing

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63. In practice, it is also suggested that the main issue is not “what is in the regulation” but “what is the regulation.” In other words, the concern with the contents of a particular regulation would appear to be secondary if internationally active financial conglomerates could choose to be subject to only one set of standards, even if not very favorable. This is, of course, hard to evaluate. It would all come to a matter of degree. How far can a regime go in imposing obligations on financial conglomerates before they start fishing for most favorable jurisdictions again?

64. See Scott & Iwahara, *supra* note 48.

65. See Clark, *supra* note 40.

66. See Scott & Iwahara, *supra* note 48.

67. The most notable divide among *countries* until very recently came indeed from what has commonly been termed “the separation theme,” so named because the business of banking must be separated from insurance and/or securities activi-

banks were subject to supervision in the United States. This was at odds with the European system where “universal banks” were allowed to engage in both banking and securities dealing. Investment bank holding companies thus benefited from a considerable competitive advantage over both U.S. bank/financial holding companies and European universal banks. The Capital Adequacy Directive now requires these investment bank groups to be subject to equivalent regulation.<sup>68</sup> While the justification given to introduce this measure rested on prudential considerations, the fact that broker-dealers are often seen as not presenting the same systemic risks as banks suggests that there is another plausible rationale for this enhanced regulation, and that is to

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ties. Clark circumscribes this theme as follows: “regulation sharply limits the ways in which financial-intermediary activities proper, that is, banking and insurance, may be connected to other activities.” Clark, *supra* note 40, at 789-90. Richard Dale focuses on the separation between banking and securities and identifies three arguments for it:

[F]irst, that securities business is more risky than ordinary commercial banking and can thereby threaten banking insolvencies; second, that the mixing of banking and securities involves conflicts of interest that can lead to widespread abuses; and finally, that these potentially damaging consequences of mixed banking can be avoided only by prohibiting banks from engaging in certain securities activities, and not by less drastic forms of regulation.

Dale, *supra* note 17, at 220-221. Thus, while in the United States and Japan, banks were, as a rule, not allowed to engage in insurance or securities underwriting, in most European jurisdictions such cross-sectoral operations were permitted. The separation of banking and insurance/securities was originally conceived of as a regulatory strategy to ensure the soundness of banks and to avoid the development of anticompetitive practices. After the 1929 U.S. stock market crash, there was a widespread belief that the securities activities of banks were responsible for the wave of bank failures. See Edward J. Perkins, *The Divorce of Commercial and Investment Banking: A History*, 88 *BANKING L. J.* 483, 499-500 (1971). In this context, the holding company structure came to provide a way to get around separation. As groups became increasingly diversified, the regulatory techniques used to regulate them were progressively modified, going from approaches imposing mostly negative obligations, such as activities restrictions, to approaches involving affirmative “enhanced” obligations at the financial holding company level, seeking in particular to pass on to parents the financial burden in case of insolvency of their subsidiaries. See Jackson, *Expanding Obligations*, *supra* note 26, at 510-11. The introduction of the Gramm-Leach-Bliley Act in 1999 suppressed, however, most of what remained from the separation strategy, allowing U.S. groups to operate simultaneously through subsidiaries in the banking, insurance and securities sectors.

68. Capital Adequacy Directive, Council Directive 93/6, 1993 O.J. (L141) 1 (EEC) [hereinafter Capital Adequacy Directive].

remove the competitive advantages investment bank groups have enjoyed so far and establish a level-playing field more favorable to European groups. This is all the more so if one takes into account the high degree of concentration of the investment bank industry.<sup>69</sup> The response of the SEC to the Financial Conglomerates Directive, namely the adoption of two new regulatory frameworks applicable to investment bank groups,<sup>70</sup> points in the same direction. The advantageous capital requirements offered to large investment bank groups can, in this context, be analyzed as an “uncovered” policy striking a careful balance between prudential and competitive considerations. As such, this response seems less disruptive than the alternative of harmonizing the rules while covertly adjusting the level of enforcement.

This point will become clearer when this article discusses in more detail the current developments in the European Union, the United States, and Switzerland. Suffice it for now to emphasize that the regulation of financial groups rests on considerations that do not necessarily converge. The prudential and competition rationales are, at the margin, in conflict with each other, and the overall environment in which financial groups operate may vary widely across countries.

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69. Although this high degree of concentration is well established, little empirical research exists on the specific effects it may have on competition. According to the aforementioned Group of Ten *Report on Consolidation in the Financial Sector*:

On balance, evidence suggests that investment banks may be exerting some degree of market power. Moreover, the importance of reputation and the placing power of underwriters may create a barrier to entry that is likely to survive even the technological developments foreseeable in the near future. Therefore, in-market consolidation among large firms could affect negatively their consumers.

The investment banking industry is highly internationalized, as the largest firms are chartered in many different countries. However, the market is highly concentrated: a small group of firms dominates each segment. For example, the market share of equity underwriting of the five largest firms is above [fifty percent] both in the [United States] and Europe. Nonetheless there is little research available on the degree of competition in the investment banking sector.

In Italy, a thorough examination by the antitrust authorities concluded that, even though the market for investment banking was dominated by a small number of firms, there was no evidence of abuses. In contrast, studies of U.S. securities markets found evidence of anticompetitive pricing and procompetitive effects of entry.

Group of Ten, *supra* note 41, at 25.

70. See *supra* notes 7-10 and accompanying text.

This represents a huge challenge for legislatures and regulatory agencies, which are forced to balance these competing considerations. As discussed in the next section, the use of equivalence as the underlying approach towards integration in the regulation of financial groups has provided rule-makers with larger room for striking a balance which so far seems not only politically sensible but also economically satisfactory.

## II. THE CURRENT REGULATION OF FINANCIAL GROUPS

### A. *General Remarks*

In the preceding section this article discussed the issues that arise in the context of harmonization and equivalence as regarding rationales and techniques for the regulation of financial groups. Drawing upon these theoretical considerations, the present section analyzes the concrete mechanisms that have been set up in three specific jurisdictions, namely the European Union, the United States, and Switzerland, to achieve equivalence. The choice of this particular “sample” of regulatory regimes follows from the fact that the European Financial Conglomerates Committee and the Banking Advisory Committee have only provided “general guidance” with respect to the United States and Switzerland.<sup>71</sup> The reason for this is probably that the main third-country-regulated financial groups operating in the European Union are based either in the United States or in Switzerland.<sup>72</sup>

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71. See *supra* note 4 and accompanying text.

72. According to statistics available from the Bankscope database, in 2004 among the twenty-five largest banking groups in terms of market capitalization, only eleven were based in E.U. countries. The other fourteen were based either in the United States, Japan or Switzerland. The picture does not differ much if we consider the top twenty-five banking groups by total assets in 2004. The most relevant difference for this discussion is the inclusion of the People's Bank of China at twenty-second place. One must however take into account that some of these groups may not qualify as financial conglomerates within the meaning given by the Financial Conglomerates Directive. For instance, ABN AMRO Holding NV, which ranks first in terms of total assets, has not been identified in the list prepared by the Mixed Technical Group on the Supervision of Financial Conglomerates. E.U. Financial Conglomerate Commission, Sub-Comm. on the Supervision of Fin. Conglomerates, Mixed Technical Group, *Implementation of Directive 2002/87/EC - the Financial Conglomerates Directive: Identification of financial conglomerates* (July 29, 2005). Moreover, they may also vary as to their involvement in the European Union. In any case, this gives a very rough picture of what “third regulators” may come into play.

The section is structured into three parts. The first part deals with the changes undergone by each of the three jurisdictions with respect to financial conglomerates. In order to examine the extent to which equivalence has been the true engine of convergence in this field, particular emphasis is given to the interactions between the different regulatory initiatives. The second part focuses on equivalence in its narrow sense, and particularly on how the British FSA is currently handling equivalence determinations. The third part deals with the specific issue of information exchange among different authorities. As will be shown, despite some initial reluctance, an apparently satisfactory compromise has been achieved between the two most concerned regulatory authorities, namely the SEC and the British FSA.

### *B. Recent Developments in the Regulation of Financial Conglomerates*

*The European framework*—Given the reactive nature of both the U.S. and Swiss new regulation on Financial Groups, it is useful to start with a discussion of what they are reacting to, namely the Financial Conglomerates Directive. The Directive can be seen as one step, among many others, towards a European integrated financial market,<sup>73</sup> but it also reflects, more generally, the principles developed by the Group of Ten Joint Forum on this matter.<sup>74</sup> Apart from these very

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73. The overall framework was set by the Financial Services Action Plan (FSAP) adopted by the European Commission on May 11, 1999, itself a result of the “Lisbon” commitment to make Europe the world’s most competitive knowledge-based economy by 2010. Within this framework, there were worries that:

[T]he heightened consolidation in the [financial] industry, and the intensification of links between financial markets call for careful consideration of structures for containing and supervising institutional and systemic risk, in particular where they arise in cross-sector groups combining insurance companies, banks and investment firms . . . . The aim of this Directive is therefore to ensure the stability of European financial markets, to establish common prudential standards for the supervision of financial conglomerates throughout Europe, and to introduce level playing fields and legal certainty between financial institutions.

*Commission Proposal for a Directive of the European Parliament and of the Council on the Supplementary Supervision of Credit Institutions, Insurance Undertakings and Investment Firms in a Financial Conglomerate*, at 2, COM (2001) 213 final (Apr. 24, 2001).

74. The Group of Ten (G-10) Joint Forum is a multilateral regulatory working group established in 1996. It serves as the umbrella of the Basel Committee on Banking Supervision, the International Organization of Securities Commissions and



broad remarks, it is difficult to describe the regulatory framework established by the Financial Conglomerates Directive without introducing considerable complexity into the picture. In order to keep the presentation as clear as possible, it can be helpful to make some distinctions. The first distinction is quite obvious and focuses on the difference between regulatory frameworks and enforcement structures. The second adopts a different approach distinguishing between a top-down perspective of regulation, which ranges from solo to group-level supervision, and a functional one, which concentrates instead on the particular type of activity being regulated. As demonstrated ahead, the Financial Conglomerates Directive is located respectively at the highest and broadest extreme. Finally, a third useful distinction can be drawn between financial conglomerates headed from within the European Union and those whose headquarters are located in a third country. This article will analyze the overall framework from the perspective of these three distinctions.

Concerning the first distinction, the underlying idea is fairly obvious: regulatory harmonization through the enactment of directives is not the same as enforcement convergence. Different states may (and do) apply harmonized standards in different ways, thus allowing for some enforcement disparity. To understand the way the system operates in practice, it is important to keep in mind that harmonizing regulatory standards is only a first step towards implementing a harmonized framework. This point will be discussed later.

For now, the focus is on the second distinction mentioned, which concerns regulatory standards. Three main supervisory layers can be identified.<sup>75</sup> The first is intended to regulate banks, insurance companies and securities firms on a stand alone basis.<sup>76</sup> The second layer

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the International Association of Insurance Supervisors. The Directive is largely based on the Joint Forum's previous work. *See id.* at 2.

75. *See* Frank Dierick, *The Supervision of Mixed Financial Services Groups in Europe*, 20 EUROPEAN CENTRAL BANK OCCASIONAL PAPER SERIES 1, at 48-50 (Aug. 2004) (providing the definition of legal terms); Michael Gruson, *Supervision of Financial Conglomerates in the European Union*, 19 J. INT'L BANKING L. & REG. 364 (2004).

76. *See* Dierick, *supra* note 75, at 20. The main legal instruments are: the *Consolidated Banking Directive* (Council Directive 2000/12, 2000 O.J. (L 126) 1 (EC) (relating to the taking up and pursuit of the business of credit institutions)); *Life Assurance Directive* (Council Directive 2002/12, 2002 O.J. (L 77) 11 (EC) (concerning life assurance)); *Non-Life Insurance Directive* (Council Directive 73/239, 1973 O.J. (L 228) 3 (EEC) (on the coordination of laws, regulations and administrative provisions relating to the taking-up and pursuit of the business of direct insurance other

adopts a group-level or consolidated perspective but remains functionally restricted.<sup>77</sup> The Consolidated Banking Directive<sup>78</sup> provides for consolidated supervision of credit institutions<sup>79</sup> that, alternatively, have either another credit institution or a financial institution<sup>80</sup> as a subsidiary or hold a participation of twenty percent or more of the voting capital in such an institution,<sup>81</sup> or that are subsidiaries of a financial holding company.<sup>82</sup> The Capital Adequacy Directive<sup>83</sup> also requires consolidated supervision<sup>84</sup> for groups headed by an investment firm<sup>85</sup> and holding a credit institution, another investment firm or another financial institution or participation therein, or, conversely, for investment firms whose parent-entity is a financial holding company.<sup>86</sup> The Insurance Groups Directive<sup>87</sup> requires<sup>88</sup> consolidated supervision of those insurance undertakings<sup>89</sup> that own or hold a partici-

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than life insurance)); *Investment Services Directive* (Council Directive 93/22, 1993 O.J. (L 141) 27 (EEC) (on the investment services in the securities field)).

77. *See generally* Dierick, *supra* note 75.

78. Council Directive 2000/12, art. 52(1)-(2), 2000 O.J. (L 126) 1 (EC) [hereinafter Consolidated Banking Directive].

79. *See id.* art. 1(1) (defining “credit institution” as “an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account”).

80. *See id.* art. 1(5) (defining “financial institution” as “an undertaking other than a credit institution, the principal activity of which is to acquire holdings or to carry on one or more of the activities listed in points 2 to 12 of Annex I,” with the exception of acceptance of deposits and other repayable funds including activities that are also permitted to an investment firm, but not insurance).

81. *See id.* art. 1(9).

82. Gruson, *supra* note 75, at 364 (citing Consolidated Banking Directive, *supra* note 78, art. 1(21)) (defining “financial holding company” as a “financial institution the subsidiary undertakings of which are either exclusively or mainly credit institutions or financial institutions, at least one of such subsidiaries being a credit institution, and which is not a mixed financial holding company”).

83. Capital Adequacy Directive, *supra* note 68.

84. *Id.* art. 7(2)-(3).

85. Council Directive 93/22, art. 1(2), 1993 O.J. (L 141) 1 (EEC). The directive states that an investment firm is any legal person whose regular occupation or business consists of the provision of investment services for third parties on a professional basis. *Id.* The investment services covered include the reception, transmission and execution of orders, underwriting and portfolio management. *Id.*

86. Capital Adequacy Directive, *supra* note 68, art. 7(2)-(3).

87. Council Directive 98/78, 1998 O.J. (L 288) 1 (EC).

88. *Id.* art. 2.

89. *Id.* art. 1(a). Article 1(a) states “insurance undertaking means an

pation<sup>90</sup> or are horizontally linked<sup>91</sup> to another insurance undertaking (European or not<sup>92</sup>) or a reinsurance undertaking,<sup>93</sup> or, conversely, that are owned or held by such undertakings or by a mixed-activity insurance holding company.<sup>94</sup> Finally, the third regulatory layer concerns financial conglomerates, namely cross-sectorial groups of a predominantly financial nature, as opposed to mixed-activity groups, which combine commercial and/or industrial activities with some financial services.<sup>95</sup> Before going into more detail, this article summarizes graphically the overall regulatory framework in Europe:

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undertaking which has received official authorisation in accordance with article 6 of Directive 73/239/EEC or article 6 of Directive 79/267/EEC." *Id.*

90. *Id.* art. 1(f). Article 1(f) states: "participation means participation within the meaning of Article 17, first sentence, of Directive 78/660/EEC (9) or the holding, directly or indirectly, of [twenty percent] or more of the voting rights or capital of an undertaking." *Id.* (citation omitted).

91. *See* Gruson, *supra* note 75, at 365 (explaining that "horizontally linked" refers to those cases where control is not based on an equity investment but rather on unified management or cross-membership of governing boards).

92. Council Directive 98/78, art. 1(b), 1998 O.J. (L 3301) 1 (EC). Article 1(b) states: "non-member-country insurance undertaking means an undertaking which would require authorisation in accordance with Article 6 of Directive 73/239/EEC or Article 6 of Directive 79/267/EEC if it had its registered office in the Community." *Id.*

93. *Id.* art. 1(c). Article 1(c) states: "reinsurance undertaking means an undertaking, other than an insurance undertaking or a non-member-country insurance undertaking, the main business of which consists in accepting risks ceded by an insurance undertaking, a non-member-country insurance undertaking or other reinsurance undertakings." *Id.*

94. *Id.* art. 1(j). Article 1(j) states: "mixed-activity insurance holding company means a parent undertaking, other than an insurance undertaking, a non-member-country insurance undertaking, a reinsurance undertaking or an insurance holding company, which includes at least one insurance undertaking among its subsidiary undertakings." *Id.*

95. *See generally* Dierick, *supra* note 75, at 20. These groups are merely required to supply the information necessary to regulate their bank or insurance subsidiary. *Id.* Supervisory obligations are more comprehensive, however, in the case of mixed-activity insurance holding companies. *Id.*

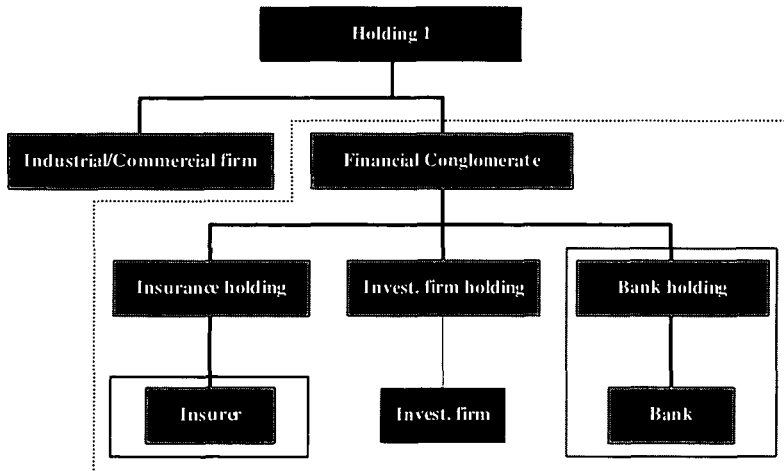
EXHIBIT 2: LEVELS OF REGULATION IN THE EUROPEAN UNION<sup>96</sup>

Exhibit 2 illustrates the three levels at which European regulation intervenes. The thin black line represents an example of solo regulation, focusing here on insurance. The gray line provides an example of consolidated functional regulation, as is the case of credit institutions or banks. The dotted line is the level at which the Financial Conglomerates Directive is intended to operate, namely that of groups active across financial sectors. Finally, mixed-activities groups involving substantial commercial or industrial components are not comprehensively regulated.<sup>97</sup> Whereas this stylized characterization may be useful to grasp the basic idea, it is important to keep in mind that the definition of what precisely constitutes a financial conglomerate subject to supplementary supervision is highly technical and covers, so far, some sixty groups based in the enlarged European Union,<sup>98</sup> to

96. Adapted from *id.*

97. *Id.*

98. See *Implementation of Directive 2002/87/EC*, *supra* note 52 (identifying the financial groups that would fall under the Directive). It must be noted, however, that this list is by no means definitive. Groups with their head office in Austria, Belgium, France, Finland, Greece, Portugal, and Slovenia have not yet been reported and, even after one group has been included, the “coordinator” may decide that the group will be partially or totally exempted from supplementary regulation. More-

which we must add many foreign groups operating in Europe and headed mostly in the United States, Switzerland and Japan. Before moving onto the third distinction identified above, i.e. between groups based inside and outside the European Union, it is necessary to characterize the legal concept of “financial conglomerate.”

Here, the amalgam so far maintained when speaking of groups or conglomerates indistinctively must be abandoned. For the purpose of the Financial Conglomerates Directive, an entity constituting a financial group may not constitute a financial conglomerate. More precisely, the Directive applies only if three conditions are satisfied:<sup>99</sup> a “regulated entity is part of a group;”<sup>100</sup> the “group meets the requirements to be considered as a financial conglomerate;”<sup>101</sup> and the “regulated entity is not partially or totally exempted from supplementary supervision.”<sup>102</sup> Concerning the first condition, at least one regulated entity, meaning a credit institution, an insurance undertaking, or an investment firm,<sup>103</sup> must either belong to or be the head of the group in question.<sup>104</sup> A group can exist through three types of arrangements,<sup>105</sup> a parent subsidiary relationship,<sup>106</sup> the holding of a participation,<sup>107</sup> or

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over, a final decision on the identity of supervised financial conglomerates has yet to be made. *Id.*

99. Gruson, *supra* note 75, at 366.

100. *Id.*

101. *Id.*

102. *Id.*

103. These entities are characterized by the Directives previously discussed in this section. To be a regulated entity, an institution must have its head office within the European Union.

104. Financial Conglomerates Directive, *supra* note 1, art. 2(14)(a).

105. Gruson, *supra* note 75, at 366.

106. A parent-subsidiary relationship is characterized by Council Directive 83/349, art. 1, 1983 O.J. (L 193) 1 (EEC) [hereinafter Directive 83/349] to which articles 2(9) and 2(10) of the Financial Conglomerates Directive refer. However, the group concept used in this latter Directive may go beyond the one circumscribed by the former. One such instance would be when supervisory authorities decide to include considering a particular arrangement as a group because of the dominant influence they observe. Moreover, as shown later, the concept of “group” in the Financial Conglomerates Directive also covers the participating interests held either by the parent or by its subsidiaries as well as horizontal groups. *See* Dierick, *supra* note 75, at 10.

107. As characterized by Council Directive 78/660, art. 17, 1978 O.J. (L 222) 11 (EEC), to which Article 2(11) of the Financial Conglomerates Directive refers. Financial Conglomerates Directive, *supra* note 1, art. 2(11). Article 17 states:

For the purposes of this Directive, ‘participating interest’ shall mean rights

a horizontal structure.<sup>108</sup> Second, to be a financial conglomerate the group must further be substantially involved in financial activities.<sup>109</sup> The tests for this involvement vary according to whether the group is headed by an E.U.-regulated entity, as defined above. In all cases the group must be significantly engaged<sup>110</sup> in, on the one hand, insurance

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in the capital of other undertakings, whether or not represented by certificates, which, by creating a durable link with those undertakings, are intended to contribute to the company's activities. The holding of part of the capital of another company shall be presumed to constitute a participating interest where it exceeds a percentage fixed by the Member States which may not exceed [twenty percent].

Council Directive 78/660, art. 17, 1978 O.J. (L 222) 11 (EEC). Article 2(11) of the Financial Conglomerates Directive adds: "the direct or indirect ownership of [twenty percent] or more of the voting rights or capital of an undertaking." Financial Conglomerates Directive, *supra* note 1, art. 2(11).

108. This modality is defined in Council Directive 83/349, art. 12(1), 1983 O.J. (L 193) 1 (EEC), to which Article 2(12) of the Financial Conglomerates Directive refers. The existence of a horizontal group is based on contracts or provisions in the corporate charters implying the unified management of a number of apparently unaffiliated organizations. Alternatively, a high degree of cross-membership in the boards of different organization may imply the existence of a horizontal group. See Dierick, *supra* note 75, at 19.

109. Financial Conglomerates Directive, *supra* note 1, art. 2(14).

110. The significance test is laid out in Article 3(2)-(3) of the Financial Conglomerates Directive:

2. For the purposes of determining whether activities in different financial sectors are significant within the meaning of Article 2(14)(e), for each financial sector the average of the ratio of the balance sheet total of that financial sector to the balance sheet total of the financial sector entities in the group and the ratio of the solvency requirements of the same financial sector to the total solvency requirements of the financial sector entities in the group should exceed [ten percent].

For the purposes of this Directive, the smallest financial sector in a financial conglomerate is the sector with the smallest average and the most important financial sector in a financial conglomerate is the sector with the highest average. For the purposes of calculating the average and for the measurement of the smallest and the most important financial sectors, the banking sector and the investment services sector shall be considered together.

3. Cross-sectoral activities shall also be presumed to be significant within the meaning of Article 2(14)(e) if the balance sheet total of the smallest financial sector in the group exceeds EUR 6 billion. If the group does not reach the threshold referred to in paragraph 2, the relevant competent authorities may decide by common agreement not to regard the group as a financial conglomerate, or not to apply the provisions of Articles 7, 8 or 9,

activities and, on the other hand, either banking or investment services. In addition to this, however, groups headed by a non-regulated entity<sup>111</sup> do not qualify as financial conglomerates unless their activities “mainly occur in the financial sector,”<sup>112</sup> which basically means that the entities of the group involved in financial activities must account for at least forty percent of the balance sheet’s total.<sup>113</sup> Qualifying as a financial conglomerate does not necessarily mean that the supplementary regulatory framework of the Directive will apply.<sup>114</sup> This is where the third condition comes in. Supplementary supervision directly concerns only certain entities, which are responsible for com-

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if they are of the opinion that the inclusion of the group in the scope of this Directive or the application of such provisions is not necessary or would be inappropriate or misleading with respect to the objectives of supplementary supervision.

*Id.* art. 3(2)-(3).

111. For instance, a group is headed by a non-regulated entity when the parent company is not subject to regulation in the European Union (e.g. commercial or industrial companies, or a financial institution other than those subject to regulation), or when the parent company is subject to regulation in a third country (e.g. foreign financial groups), or in the case of a horizontal group, which has no particular parent company.

112. Financial Conglomerates Directive, *supra* note 1, art. 2(14)(c). “[W]here there is no regulated entity within the meaning of Article 1 at the head of the group, the group’s activities mainly occur in the financial sector within the meaning of Article 3(1).” *Id.*

113. *Id.* art. 3(1).

For the purposes of determining whether the activities of a group mainly occur in the financial sector, within the meaning of Article 2(14)(c), the ratio of the balance sheet total of the regulated and non-regulated financial sector entities in the group to the balance sheet total of the group as a whole should exceed [forty percent].

*Id.* The “financial sector entities” that must be considered for this calculation are: the banking sector, including credit institutions, financial institutions, and ancillary banking undertakings; the insurance sector, including insurance undertakings, reinsurance undertakings, and insurance holding companies; the investment services sector, including investment firms and financial institutions; mixed financial holding companies; and asset management companies. *See Dierick, supra* note 75, at 11.

114. Gruson identifies two main cases where the framework does not apply: E.U.-regulated entities belonging to a financial conglomerate headed by an E.U.-regulated entity (article 5(2)(a) *a contrario*); and E.U.-regulated entities belonging to a financial conglomerate headed by an entity based outside of the European Union that is subject to equivalent foreign supervision (article 18(1)). Gruson, *supra* note 75, at 371.

pliance by the conglomerate.<sup>115</sup> These entities are the following: every regulated entity which is at the head of a financial conglomerate;<sup>116</sup> every regulated entity, the parent undertaking of which is a mixed financial holding company with its head office in the Community;<sup>117</sup> and every regulated entity linked with another financial sector entity in such a way as to constitute a horizontal group.<sup>118</sup> Moreover, regulators may extend supplementary supervision to other entities, totally or partially.<sup>119</sup> Finally, financial conglomerates whose parent undertakings are located outside of the European Union and that are not subject to “equivalent” supervision may also be subject to supplementary supervision.<sup>120</sup> This latter point leads to the third distinction identified above, between E.U.-based and foreign-based financial conglomerates.

This third distinction is particularly relevant to this topic for it lies at the very core of the equivalence issue. As already pointed out, foreign financial conglomerates active in the European Union are as a rule not subject to the supplementary supervisory framework of the Financial Conglomerates Directive. However, Article 18 paragraph 2 of the Directive states that:

In the absence of equivalent supervision referred to in paragraph 1, Member States shall apply to the regulated entities, by analogy, the provisions concerning the supplementary supervision of regulated entities referred to in Article 5(2). As an alternative, competent authorities may apply one of the methods set out in paragraph 3.<sup>121</sup>

Introduced in 2002, this provision raised serious concerns among foreign financial conglomerates, particularly those based in the United

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115. Financial Conglomerates Directive, *supra* note 1, art. 5(2)(a)-(c).

116. *Id.* art. 5(2)(a).

117. *Id.* art. 5(2)(b).

118. *Id.* art. 5(2)(c).

119. *Id.* art. 5(4). Article 5(4) states:

Where persons hold participations or capital ties in one or more regulated entities or exercise significant influence over such entities without holding a participation or capital ties, other than the cases referred to in paragraphs 2 and 3, the relevant competent authorities shall, by common agreement and in conformity with national law, determine whether and to what extent supplementary supervision of the regulated entities is to be carried out, as if they constitute a financial conglomerate.

*Id.*

120. *See generally id.* art. 5.

121. *Id.* art. 18(2)



States and Switzerland. These conglomerates were either regulated in ways not necessarily similar to the European approach or even unregulated at the group level, as was the case of American investment bank holding companies. Moreover, the Directive vested in the “coordinator”<sup>122</sup> considerable powers, including that of taking into account in its assessment of equivalence the extent to which standards are actually enforced by foreign regulators.<sup>123</sup> Therefore, the ramifications of the equivalence issue go beyond the mere determination of the regulatory standards applicable in other jurisdictions.

Largely as a response to the ongoing uncertainty, the United States and Switzerland adopted new regulatory frameworks and entered into negotiations with the different concerned European agencies in order to have this problem solved as soon as possible.<sup>124</sup> A number of guidelines were issued both at the European and national levels.<sup>125</sup> However, a preliminary step to understanding the ramifications of the equivalence issue is to ask whether the most concerned countries have in place an adequate group-level regulatory framework. The analysis of the equivalence issue can therefore not be undertaken without first reviewing these reactions.

*The U.S. regulatory reaction*—The supervisory framework dealing with financial groups in the United States has considerably changed in the last decade. As demonstrated before, banking, securities, and insurance activities were traditionally segregated in the United States. With the passing of the Gramm-Leach-Bliley Act (GLBA) in 1999, this segregation was reduced so as to have almost no effect for those groups meeting the necessary requirements to qualify as financial holding companies, pursuant to section 1843(l) of the Bank Holding Company Act (BHCA).<sup>126</sup> This new organizational

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122. *Id.* art. 11(1)(c). *See generally id.* art. 10 (appointment of and criteria for selecting the coordinator).

123. *Id.* art. 11.

124. *See supra* note 4 and accompanying text.

125. *Id.*

126. 12 U.S.C. § 1843(l) (2000). Section 1843(1) states:

Conditions for engaging in expanded financial activities: (1) In general: . . . a bank holding company may not engage in any activity, or directly or indirectly acquire or retain shares of any company engaged in any activity, under subsection (k), (n), or (o) (particularly expanded powers), other than activities permissible for any bank holding company under subsection (c)(8), unless: (A) all of the depository institution subsidiaries of the bank holding company are well capitalized; (B) all of the depository institution subsidiaries of the bank hold-

structure does not replace the previous bank holding company structure, which remains available.<sup>127</sup> It is only an additional regime offered to those groups that are doing particularly well in terms of capital and management.<sup>128</sup> Under the BHCA, responsibility for group supervision is vested exclusively in the Federal Reserve Board.<sup>129</sup> In June 2004, however, the SEC introduced two regulatory regimes that coexist with the organizational structures established by the BHCA. This article will now discuss these two regimes in more detail.

In October 2003, the SEC published two proposed rules and requested comments about them until February 2004.<sup>130</sup> These proposals concerned the establishment of a supervised investment bank holding company (SIBHC) structure,<sup>131</sup> and the introduction of

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ing company are well managed; and (C) the bank holding company has filed with the Board: (i) a declaration that the company elects to be a financial holding company to engage in activities or acquire and retain shares of a company that were not permissible for a bank holding company to engage in or acquire before the enactment of the Gramm-Leach-Bliley Act; and (ii) a certification that the company meets the requirements of subparagraphs (A) and (B).

127. *Id.*

128. This structure is also offered to those groups doing particularly well with obligations such as those found in *Community Reinvestment Act*. See 12 U.S.C. § 1843(l)(2) (2000). This act allows “the appropriate Federal banking agency” to:

[P]rohibit a financial holding company or any insured depository institution from: (A) commencing any new activity under subsection (k) or (n) of this section, section 5136A of the Revised Statutes of the United States, or sections 46(a) of the Federal Deposit Insurance Act; or (B) directly or indirectly acquiring control of a company engaged in any activity under subsection (k) or (n) of this section, section 5136A(a) of the Revised Statutes of the United States, or section 46(a) of the Federal Deposit Insurance Act . . . if any insured depository institution subsidiary of such financial holding company, or the insured depository institution or any of its insured depository institution affiliates, has received in its most recent examination under the Community Reinvestment Act of 1977, a rating of less than “satisfactory record of meeting community credit needs.”

*Id.*

129. See generally 12 U.S.C. § 1843 (2000).

130. See Supervised Investment Bank Holding Companies, 68 Fed. Reg. 62,910 (proposed Nov. 6, 2003) (to be codified at 17 C.F.R. pt. 240); Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities, 68 Fed. Reg. 62,872 (proposed Nov. 6, 2003) (to be codified at 17 C.F.R. pt. 240).

131. Supervised Investment Bank Holding Companies, 68 Fed. Reg. 62,910 (proposed Nov. 6, 2003) (to be codified at 17 C.F.R. pt. 240).

alternative net capital requirements for broker-dealers that would be part of a new structure called “Consolidated Supervised Entities” (CSEs).<sup>132</sup> In both cases, the SEC acknowledged that these proposals responded to the Financial Conglomerates Directive and the necessity of equivalent supervision to minimize duplicative regulatory burdens.<sup>133</sup> Whereas both proposals received comments, private companies and representative organizations showed substantially more interest in the proposed CSE rule.<sup>134</sup> The major concern was that of banking groups which were already subject to supervision by the Federal Reserve Board, and which feared duplicative regulation by the SEC. At the same time, these groups expressed interest in benefiting from the considerable capital relief at the broker-dealer level contemplated by the proposed rule.<sup>135</sup> The SEC took these concerns

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132. Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities, 68 Fed. Reg. 62,872 (proposed Nov. 6, 2003) (to be codified at 17 C.F.R. pt. 240).

133. Supervised Investment Bank Holding Companies, 68 Fed. Reg. 62,911 nn.3 & 9; Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities, 68 Fed. Reg. 62,874 nn.12-13.

134. The CSE proposed rule received twenty-six comments, while the SIBHC proposal received only five. *See* Comments on Proposed Rule: Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities [Release Nos. 34-48690; File No. S7-21-03] (Mar. 26, 2004), *available at* <http://www.sec.gov/rules/proposed/s72103.shtml>; Comments on Proposed Rule: Supervised Investment Bank Holding Companies [Release Nos. 34-48694; File No. S7-22-03] (Mar. 22, 2004), *available at* <http://www.sec.gov/rules/proposed/s72203.shtml>.

135. For instance, J.P. Morgan Chase commented:

The Final Rule should avoid duplicative regulation of holding company groups that are already subject to consolidated supervision by a recognized consolidated company supervisor . . . . In no event should the Commission require a Financial Holding Company or any of its affiliates (other than broker-dealers and investment advisers already subject to the jurisdiction of the Commission) to consent to group-wide or individual supervision, or subject themselves to examination, by the Commission.

J.P. Morgan Chase added later:

[T]he Proposed Rule is attractive to firms such as [J.P. Morgan Chase] only because the alternative capital calculation results in significant capital relief at the broker-dealer level. Unfortunately, a number of aspects of the Proposed Rule involve duplicative regulation for Financial Holding Companies and their affiliates which outweigh the benefit of such capital relief.

Comments of Marjorie E. Gross, Managing Director and Associate General Counsel, J.P. Morgan Chase & Co., Proposed Rule Regarding Alternative Net Capital Requirements for Broker-Dealers that Are Part of Consolidated Supervised Entities

very seriously when drafting the final rules, which were eventually published in June 2004.<sup>136</sup> In particular, the SEC explicitly considered the situation of “ultimate holding companies that have a principal regulator,” an expression covering financial holding companies under the GLBA, and granted exemptions from some requirements and reductions in others.<sup>137</sup> Before going into more detail, it is worth noting that this problem provides an interesting illustration of the different ramifications of the equivalence issue. As the SEC proposals suggest, and despite the considerable pains the SEC took not to challenge the supervisory authority of the Federal Reserve Board, these ramifications can easily develop into domestic regulatory rivalry.

Section 231 of the GLBA modified section 17 of the Securities and Exchange Act of 1934 to allow for voluntary regulation of broker-dealer holding companies.<sup>138</sup> While this amendment intervened prior

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(Feb. 12, 2004), *available at* <http://www.sec.gov/rules/proposed/s72103/jpmorganchase021204.htm>. More generally Beth L. Climo of the American Bankers Association Securities Association commented:

As a general matter, [the American Bankers Association Security Association] strongly supports the animating principle of the Proposed Rule; the availability of the benefits of the proposed alternative capital treatment to broker-dealers owned by bank holding companies; and the general recognition that, because of the nature of their regulation, bank holding companies should not be subject to all of the same regulatory requirements as unregulated affiliates of broker-dealers. Nevertheless, our members remain very concerned that the Proposed Rule does not go far enough to recognize the existing regulation already applicable to bank holding companies through their consolidated examination, reporting, capital, and risk management requirements—all of which are applicable to bank holding companies under the Federal Reserve's regulations implementing the Basel regime that the Proposed Rule appropriately recognizes as its model.

Letter from Beth L. Climo, Executive Director of the American Bankers Association Security Association, to Jonathan G. Katz, Secretary of the Securities Exchange Commission (Feb. 4, 2004), *available at* <http://www.sec.gov/rules/proposed/s72103/abasa020404.htm>. Given the high level of minimum capital required to qualify for the CSE proposed rule (1 billion U.S. dollars), only very large banking groups such as J.P. Morgan Chase, Citigroup, Bank of America, Deutsche Bank, UBS and Credit Suisse are really concerned by this tension.

136. See 17 C.F.R. §§ 200-240 (2006).

137. 17 C.F.R. § 240.15c3-1(c)(13)(ii) (2006).

138. Gramm-Leach-Bliley Act, Pub. L. No. 106-102, § 231(a), 113 Stat. 1338, 1402-1406 (1999) (amending the Securities and Exchange Act of 1934, § 17 (codified at 15 U.S.C. § 78q (2006))).

to the enactment of the Financial Conglomerates Directive, the Directive played, as already mentioned, an important role in the subsequent implementation of section 17 by the SEC. The basic idea of the SIBHC framework is to provide IBHCs that meet some eligibility requirements with the possibility of being regulated by the SEC in a way hopefully equivalent to what the Financial Conglomerates Directive requires,<sup>139</sup> thus escaping duplicative regulation as a result of their activities in Europe. The overall architecture of the regulation rests on three main elements: a voluntary application or “notice of intention” to be supervised by the SEC as an SIBHC,<sup>140</sup> a number of eligibility requirements,<sup>141</sup> and a number of regulatory requirements.<sup>142</sup> Concerning the first element, the SEC emphasizes the voluntary character of the supervisory framework. Rule 17i-2(a) uses the word “may” to characterize the move towards supervision,<sup>143</sup> and rule 17i-3(a) uses this same word with regard to the possibility of withdrawing from supervision as an SIBHC.<sup>144</sup> This notice shall include a number of items enumerated in rule 17i-2(b). As this list makes clear, for an IBHC to apply to the SIBHC several eligibility requirements must be met, which lead to the second element. In order to be eligible, an IBHC must own or control a broker or dealer<sup>145</sup> “that has substantial presence in the securities business, which may be demonstrated by a showing that the broker or dealer maintains tentative net capital of \$100 million or more.”<sup>146</sup> Moreover, the IBHC applying for supervision must not be any of the following: an affiliate of an insured bank or a savings association, with some exceptions;<sup>147</sup> a foreign bank or company;<sup>148</sup> or a foreign

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139. See 17 C.F.R. § 240.17i-1-17i-8 (2006).

140. 17 C.F.R. § 240.17i-2(a) (2006); 17 C.F.R. § 240.17i-3(a) (2006).

141. 17 C.F.R. § 240.17i-2(d)(2)(i)(B) (2006); 17 C.F.R. § 240.17i-2(a) (2006).

142. 17 C.F.R. § 240.17i-4 (2006); 17 C.F.R. § 240.17i-5 (2006).

143. Rule 17i-2(a) states: “An investment bank holding company . . . *may* file with the Commission a written notice of intention to become supervised by the Commission pursuant to section 17(i) of the Act . . . .” 17 C.F.R. § 240.17i-2(a) (2006) (emphasis added) (the Act refers to 15 U.S.C. § 78q(i) (2000)).

144. Rule 17i-3(a) states: “A supervised investment bank holding company *may* withdraw from supervision by the Commission as a supervised investment bank holding company by filing a notice of withdrawal with the Commission.” 17 C.F.R. § 240.17i-3(a) (2006) (emphasis added).

145. 17 C.F.R. § 240.17i-2(a) (2006).

146. 17 C.F.R. § 240.17i-2(d)(2)(i)(B) (2006). As shown later, this constitutes an important difference from the requirements set by the CSE regulation.

147. 17 C.F.R. § 240.17i-2(a)(1) (2006) (exempting “[a]n affiliate of an in-

bank controlling a corporation chartered in the United States for the purpose of engaging in foreign banking.<sup>149</sup> Under such conditions, an IBHC may become an SIBHC and thereby be subject to a number of regulatory requirements with regard to its group-wide internal risk management control system,<sup>150</sup> recordkeeping<sup>151</sup> and periodic reporting,<sup>152</sup> including reporting of consolidated computations of allowable capital and risk allowances consistent with the Basel Committee's standards.<sup>153</sup> Overall, the SIBHC regulation is less demanding in terms of who can benefit from it than the CSE regulation to which this article now turns.

The very core of the CSE regulation consists of a trade-off between an attractive way to compute net capital requirements at the level of a group's broker-dealer affiliates, and acceptance of consolidated supervision as a condition to benefit from the capital computation rules. The CSE proposed rule attracted much more attention than the SIBHC rule, which put considerable pressure on the SEC to modify its original proposal. Among the main challenges faced by the SEC was the extent to which the more favorable net capital requirements would be available for companies other than the largest ones.<sup>154</sup> The solution retained by the SEC stuck to the underlying rationale of reducing regulatory costs by "allowing very highly capitalized firms that have developed robust internal risk management practices to use those risk management practices, such as mathematical risk measurement models, for regulatory purposes."<sup>155</sup>

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sured bank (other than an institution described in paragraph (D), (F), or (G) of section 2(c)(2), or held under section 4(f), of the Bank Holding Company Act of 1956 (12 U.S.C. § 1841(c)(2)(D), (F), or (G) and 12 U.S.C. § 1843(f)) or a savings association") *Id.*

148. 17 C.F.R. § 240.17i-2(a)(2) (2006) states "[a] foreign bank, foreign company, or company that is described in section 8(a) of the International Banking Act of 1978 (12 U.S.C. 3106(a))." *Id.*

149. 17 C.F.R. § 240.17i-2(a)(3) (2006) excludes "[a] foreign bank that controls, directly or indirectly, a corporation chartered under section 25A of the Federal Reserve Act (12 U.S.C. 611)." *Id.*

150. 17 C.F.R. § 240.17i-4 (2006).

151. 17 C.F.R. § 240.17i-5 (2006).

152. 17 C.F.R. § 240.17i-6 (2006).

153. 17 C.F.R. § 240.17i-6(a)(1)(i) (2006).

154. *See* 69 Fed. Reg. 34,428 (June 21, 2004) introduction.

155. Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities, 69 Fed. Reg. 34,428 (June 21, 2004) (to be codified at 17 C.F.R. §§ 200 and 240).

As with the SIBHC regulation, one can pin down the CSE regulation's architecture to three main elements: a voluntary application procedure,<sup>156</sup> an alternative method of computing deductions to net capital for certain broker-dealers,<sup>157</sup> and the acceptance of consolidated regulatory oversight by the SEC, with some exceptions.<sup>158</sup> The first element presents no complexity so it will not be discussed further.<sup>159</sup> The second element is much more complex.<sup>160</sup> The basic idea behind this alternative computation method is that using in-house market and credit risk models will probably result in lower reductions to net capital than using the standard net capital rule.<sup>161</sup> In short, groups with broker-dealers affiliates will incur in "capital gains" overall because their capital requirements at the broker-dealer level will be lower.<sup>162</sup> However, paragraph (a)(7)(i) of Rule 15c3-1 sets the minimum bar higher than what most broker-dealers would be able to attain. Indeed, a broker or dealer that has been approved to calculate its net capital under Appendix E must, in particular "[a]t all times maintain tentative net capital of no less than \$1 billion and net capital of not less than \$500 million."<sup>163</sup> Third,

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156. 17 C.F.R. § 240.15c3-1e(a) (2006).

157. 17 C.F.R. § 240.15c3-1e (2006).

158. 17 C.F.R. § 240.15c3-1g(a-d) (2006).

159. 17 C.F.R. § 240.15c3-1e(a) (2006). "A broker or dealer may apply to the Commission for authorization to compute deductions for a market risk pursuant to this Appendix E in lieu of computing deductions pursuant to §§ 240.15c3-1(c)(2)(vi) and (c)(2)(vii) . . ." *Id.* Subparagraph (1) of 15c3-1e(a) lists the items that must be submitted with the application, which, as in the SIBHC framework, may operate as eligibility requirements. *Id.*

160. The detail of this alternative methodology is given in deductions for market and credit risk for certain brokers or dealers, 17 C.F.R. § 240.15c3-1e (2006).

161. *See* 17 C.F.R. § 240.15c3-1e (2006) preliminary note.

162. 17 C.F.R. § 240.15c3-1e (2006).

163. Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities, 69 Fed. Reg. 34,428 (June 21, 2004) (to be codified at 17 C.F.R. §§ 200 and 240). This requirement was upheld despite a number of comments submitted during the consultation period asking for a lower threshold:

One commenter stated that we should permit a broker-dealer with tentative net capital of less than \$1 billion to use the alternative net capital computation if it is an affiliate of an international bank with consolidated capital of over \$1 billion. Another commenter asserted that "the Commission should permit other broker-dealers in the CSE group-wide affiliate structure" to use the alternative method of computing net capital even if those broker-dealers do not meet the minimum capital levels. These comments, however, do not take into account certain regulatory and bankruptcy con-

alternative capital computation comes at the price of submitting to consolidated regulation of the group including requirements for the computation of allowable capital and risk allowances,<sup>164</sup> as well as reporting<sup>165</sup> and recordkeeping<sup>166</sup> requirements. Broadly speaking, these requirements involve providing information about the financial and operational condition of the ultimate holding company, complying with rules regarding the implementation and documentation of a comprehensive group-wide risk management system, consenting to SEC examination of the ultimate holding company and its material affiliates, and reporting monthly group-wide allowable capital and allowances for market, credit, and operational risk in accordance with the Basel standards.<sup>167</sup>

As shown before, this condition raised great concern from those holding companies that, while owning broker-dealers, were already subject to comprehensive consolidated supervision, as well as, more generally, from highly supervised companies belonging to groups including broker-dealers. This was particularly the case of the new Qualified Financial Holding Companies established under the GLBA. The CSE regulation thoroughly addressed this issue by imposing more limited commitments<sup>168</sup> on entities that have a principal regulator<sup>169</sup> and ultimate holding companies under the Bank Holding Company Act.<sup>170</sup> Despite these guarantees, only five institutions have so far

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siderations.

*Id.* at 34,430-31.

164. 17 C.F.R. § 240.15c3-1g(a) (2006).

165. 17 C.F.R. § 240.15c3-1g(b) (2006).

166. 17 C.F.R. § 240.15c3-1g(c)-(d) (2006).

167. As noted by one commentator “[t]his effectively extends the Basel II provisions through the back door to the big five U.S. investment banks, in addition to the roughly [twenty] commercial banks to which the new capital adequacy accord [is supposed to] apply in America.” *US Investment Firms March to the Basel II Drum*, GLOBAL RISK REGULATOR NEWSLETTER, Apr., 2004, available at <http://www.globalriskregulator.com/archive/April2004-07.html>.

168. Broadly speaking, the SEC “will not examine any entity that has a principal regulator and . . . will use the reports that it files with its principal regulator for our regulatory purposes, to the greatest extent possible.” *Alternative Net Capital Requirements for Broker-Dealers that Are Part of Consolidated Supervised Entities*, 69 Fed. Reg. 34,428, 34,431 (June 21, 2004).

169. See 17 C.F.R. §240.15c3-1(c)(13)(i) (2006). This type of entity includes insured depository institutions, futures commission merchants, entities licensed by a State insurance regulator and certain foreign banks. *Id.*

170. See 17 C.F.R. § 240.15c3-1(c)(13)(ii) (2006). This category includes any



opted for CSE status, namely Merrill Lynch,<sup>171</sup> Goldman Sachs,<sup>172</sup> Morgan Stanley,<sup>173</sup> Lehman Brothers,<sup>174</sup> and Bear Stearns.<sup>175</sup>

The two frameworks reviewed represent, with the already existing financial holding company regime, the main responses the United States can use to deal with the requirements imposed by the Financial Conglomerates Directive on third-country groups. While the existence of these regimes gives U.S. groups active in Europe a strong argument to avoid supplementary supervision by a European regulator, there is no guarantee that they will be considered "equivalent." In this regard, the political compromises that may arise out of negotiation within the framework of the E.U.-U.S. Regulatory Dialogue are as important as the specific contents of a given regime. The determination of equivalence may operate as a bargaining resource to achieve other related, though different, concessions from the counterparty. As shown next, the relations between European and Swiss regulators offer another good illustration of this point.

*The Swiss reaction*—In Switzerland, until very recently, there was no formal regulation specifically targeting heterogeneous financial groups. An international briefing on Switzerland rightly noted:

[T]he regulatory concept applicable to heterogeneous financial conglomerates is that of solo-plus supervision, i.e. the Federal Banking Commission (FBC) is in charge of supervising the banking side of the conglomerate, and the Federal Insurance Office (FIO) is called in to supervise the insurance side. The lead regulator (either the FBC or the FIO, depending on the supervised conglomerate) additionally assesses the quality of the conglomerate in terms of capital adequacy, liquidity, risk, diversification and organ-

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financial holding company or company that is treated as such under the Bank Holding Company Act of 1956 (e.g. foreign bank that has adopted the financial holding company status). *Id.*

171. Order Regarding Alternative Net Capital Computation for Merrill Lynch, Exchange Act Release No. 50,925, 69 Fed. Reg. 78,509-01 (Dec. 23, 2004).

172. Order Regarding Alternative Net Capital Computation for Goldman, Sachs, Exchange Act Release No. 51,421, 85 SEC Docket 147 (Mar. 23, 2005).

173. Order Regarding Alternative Net Capital Computation for Morgan Stanley, Exchange Act Release No. 52,145, 70 Fed. Reg. 44,701-01 (July 28, 2005).

174. Order Regarding Alternative Net Capital Computation for Lehman Brothers, Exchange Act Release No. 52,753 70 Fed. Reg. 69,614-01 (Nov. 9, 2005).

175. Order Regarding Alternative Net Capital Computation for Bear Stearns, Exchange Act Release No. 52,857, 70 Fed. Reg. 72,682-01 (Nov. 30, 2005).

izational and personnel requirements, in each case on a consolidated basis.<sup>176</sup>

To be more precise, the main divide has traditionally been between the banking and securities sectors, subject to the supervision of the Swiss Federal Bank Commission (SFBC), and the insurance sector, supervised by the Federal Office of Private Insurance (FOPI), the Federal Social Insurance Office (FSIO), and cantonal (state) regulators. However, the increasing conglomeration between banking/securities and insurance, as well as external pressure,<sup>177</sup> has led in recent years to a series of attempts at providing a comprehensive solution to this development.<sup>178</sup> Among these efforts, two are particularly relevant to this discussion, namely the enactment of a federal statute on the supervision of insurance undertakings

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176. See *Switzerland: Supervision of Financial Conglomerates*, INT'L FIN. L. REV., July 1999, available at <http://www.iflr.com/?Page=5&ISS=11973> (follow "Switzerland-Switzerland" hyperlink located under "International Briefings" section).

177. The 2004 Annual Report of the Swiss Federal Banking Commission notes the sometimes reluctant tone in which the European Financial Conglomerates Committee and the European Banking Committee describe the absence of a formal legal base for the regulation of financial conglomerates. The SFBC underlines however that such reluctance is unjustified, citing as examples its pioneer efforts in regulating the Credit Suisse Group or the positive relationship it has developed with the British FSA in recent times. See *Rapport de gestion*, 2004, pp. 114-15. This article comes back to this issue later on, focusing on the specific challenges for the exchange of information. Suffice it to say, for now, that the comments of the SFBC illustrate how the equivalence issue may be perceived as an instrument to put pressure on the related, though separate, question of information exchange and banking secrecy.

178. See, e.g., *Surveillance intégrée des marchés financiers* [Integrated supervision of financial markets], Premier rapport partiel de la Commission d'experts mise sur pied par le Conseil fédéral [First partial report of the expert commission established by the federal council, Zimmerli Report], July 2003 (Switz.) (including a preliminary legislative project). Currently, there is an ongoing legislative project on this matter. *Projet de loi fédérale sur l'autorité fédérale de surveillance des marchés financiers* [LFINMA].

(LSA),<sup>179</sup> and the amendments to the federal banking law introduced thereby.<sup>180</sup>

Concerning the first, chapter 6 of the LSA deals specifically with the supervision of insurance conglomerates,<sup>181</sup> authorizing the “relevant authority” to supervise any conglomerate involving a Swiss insurance affiliate provided such conglomerate is effectively directed from within Switzerland or, if directed from outside, when it is not equivalently supervised.<sup>182</sup> It is important to note that supervision is not compulsory but stems rather from a discretionary decision of the supervisory authority.<sup>183</sup> If such authority deems it appropriate, then the conglomerate will be subject to “supplementary” supervision in addition to that required at the individual and group level.<sup>184</sup> The contents of this supplementary supervision include what is called the “guarantee of irreproachable activity,”<sup>185</sup> capital requirements,<sup>186</sup> internal risk regulation,<sup>187</sup> the requirement of external audit,<sup>188</sup> and a specific reporting obligation imposed on the governing body or the

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179. LSA, *supra* note 11. For the rationales underlying the enactment of this Act see generally Message concernant une loi sur la surveillance des entreprises d'assurance et la modification de la loi fédérale sur le contrat d'assurance [Message regarding Statute on the Supervision of Insurance Undertakings and Modification of the Federal Statute on the Insurance Contract], May 9, 2003, Feuille Fédérale [FF] 03.035 May 9, 2003 (Switz.).

180. FBA, *supra* note 11, arts. 3b-3h.

181. Article 72 defines an insurance conglomerate as follows: two or more undertakings; including at least one insurance undertaking and either a bank or a securities firm of considerable economic importance; their overall activity being predominantly in the insurance sector; forming an economic unit or linked by means of control or influence. *See also* Ordonnance du 9 novembre 2005 sur la surveillance des entreprises d'assurance privées [hereinafter OS], [Ordinance of November 9, 2005 on the Supervision of Private Insurance Undertakings], Nov. 9, 2005, RS 961.011 (Switz.) (regulation implementing the LSA, see Title 8 in particular, dealing with insurance groups and conglomerates).

182. LSA, *supra* note 11, art. 73(1)(a) and (b).

183. Article 73(1) states: “The supervisory authority *can* subject to supervision . . . .” (emphasis added).

184. *Id.* art. 74.

185. Article 75 refers to articles 14 and 22 of the LSA regarding the standards applicable to the persons in top management and oversight positions. *Id.* art. 75.

186. *Id.* art. 77; *see also* OS, arts. 204 to 206.

187. LSA, *supra* note 11, art. 76.

188. *Id.* art. 78.

legal and physical persons to whom governing authority is delegated.<sup>189</sup>

Regarding the regulation of large banking groups such as UBS or Credit Suisse Group, the LSA has introduced a new framework in the form of amendments to Articles 3*b* to 3*h* of the Federal Banking Act (FBA). A financial group may be defined by the presence of either a bank or securities firm within a group of companies forming an economic entity mainly active in the financial sector.<sup>190</sup> Groups including at least one insurance company but active mainly in either banking or securities are considered financial conglomerates dominated by the corresponding sector.<sup>191</sup> An entity meeting the preceding criteria may<sup>192</sup> be subject to consolidated regulation by the SFBC if it either holds a bank or a broker-dealer organized under Swiss law or is effectively directed from within Switzerland.<sup>193</sup> Supervision at the group/conglomerate level is exerted in addition to that at the regulated entity level.<sup>194</sup> Articles 3*f* to 3*h* circumscribe the substance of consolidated supervision. In particular, they delegate broad powers to the SFBC with respect to capital and liquidity requirements, internal risk regulation, accounting standards,<sup>195</sup> audit requirements<sup>196</sup> and imposing on groups/conglomerates a broad disclosure obligation<sup>197</sup> as well as a “guarantee of irreproachable activity.”<sup>198</sup> Moreover, even before this new framework entered into force, the SFBC had adopted, in April 2004, Circular No. 04/1 on the Supervision of Large Banks,<sup>199</sup> setting the modalities in which

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189. *Id.* arts. 79, 47.

190. FBA, *supra* note 11, art. 3c(1).

191. *Id.* art. 3c(2).

192. Article 3d paragraph 1 FBA states that “The Banking Commission *can* subject . . .” (emphasis added). *Id.* art. 3d(1).

193. *Id.* art. 3d. Paragraph 2 addresses cases in which foreign regulatory agencies claim jurisdiction to oversee the group.

194. *Id.* art. 3f. Moreover, according to article 3b of the FBA, “when a bank intends to operate as part of a financial group or conglomerate, the SFBC can make the granting of the banking license conditional to the acceptance of consolidated supervision of the whole group.” *Id.* art. 3b.

195. *Id.* art. 3g.

196. *Id.* art. 3h(1)-(2).

197. *Id.* art. 3h(3).

198. *Id.* art. 3f(1).

199. *See generally* CFB 04/1, *supra* note 11. This article uses an unofficial translation established by KPMG. There is no comprehensive statutory framework dealing with the consolidated supervision of banks. However, many provisions of

oversight was to be conducted. This circular deals in particular with two supervisory techniques, namely “direct audits” performed by the SFBC and “in-depth audits” performed by an auditing firm on the basis of specific instructions by the SFBC. Direct audits allow the SFBC to reach its own assessment of a particular area of a large bank or of the banking system as a whole, through repeating the same procedure for several large banks.<sup>200</sup> Although they are considered as “independent acts of supervision,” duplication of auditing efforts by the SFBC, auditing firms and internal auditors must be avoided as far as possible.<sup>201</sup> Concerning “in-depth audits,” they are carried out by auditing firms<sup>202</sup> under a mandate from the SFBC setting the object, scope and timing of the audit.<sup>203</sup> This instrument is, as a rule, used to assess the risk involved in a particular business area or to develop recommendations thereupon.<sup>204</sup> The Circular also prescribes a number of reporting obligations as well as regular contacts with the banking group, the internal auditors, and the auditing firms concerned.<sup>205</sup>

Overall, this emerging supervisory regime seems to be an outgrowth of informal regulatory practices conducted until recently by the relevant authorities, at least as regards the Circular on the Supervision of Large Banks. From the European point of view, there had been some reluctance to consider such soft instruments as setting a strong enough basis for equivalent regulation, an attitude that may have catalyzed the adoption of the new statutory framework. However, as is discussed next, the reasons for this reluctance seem to

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the Federal Banking Act and its main implementing regulation, Ordonnance du 17 mai 1972 sur les banques et les caisses d'épargne, deal with different aspects of consolidated supervision. See generally FBA, *supra* note 11; Ordonnance du 17 mai 1972 sur les banques et les caisses d'épargne [OB], [Ordinance of May 17, 1972 on Banks and Savings Banks], May 17, 1972, RS 952.02 (Switz.); Carlo LOMBARDINI, LE DROIT BANCAIRE SUISSE, [Swiss Banking Law] 21 (2002); Peter Nobel, *Bank- und Finanzkonglomerate- Eine aufsichtrechtliche Auslegeordnung*, in AKTUELLE RECHTSPROBLEME DES FINANZ- UND BÖRSENPLATZES SCHWEIZ 171 (2000).

200. CFB 04/1, *supra* note 11, para. 4.1.

201. *Id.* para. 4.2.

202. Characterized as “auditors approved by the Banking Commission pursuant to Art. 20 BankL or Art. 18 SESTL.” *Id. Glossary of Terms* A5.

203. The specific term is “audit étendu” (Vertiefte Prüfung) to be distinguished from “audit approfondi” (Schwerpunktprüfung), where the object, scope and timing of the audit are decided by the auditing company. *Id. Glossary of Terms* A6 (German/English version).

204. CFB 04/1, *supra* note 11, para. 5.1.

205. See *id.* paras. 1-2.

be related not only to fears as to the actual effectiveness of the system but to political considerations as well.

### *C. Determining Equivalence*

After the enactment of the Financial Conglomerates Directive, with its requirement that third-country groups operating in the European Union be equivalently regulated, one of the most pressing issues that immediately arose was that of who would be in charge of determining equivalence. Article 18 paragraph 1 of the Directive states:

The verification [of equivalence] shall be carried out by the competent authority which would be the coordinator if the criteria set out in Article 10(2) were to apply . . . . That competent authority shall consult the other relevant competent authorities, and shall take into account any applicable guidance prepared by the Financial Conglomerates Committee in accordance with Article 21(5).<sup>206</sup>

The relative uncertainty left by this phrasing was addressed by the Mixed Technical Group on the Supervision of Financial Conglomerates in its “Issues Schedule,”<sup>207</sup> albeit not in an entirely satisfactory way. Item 46 of the Schedule raised the question of which authority shall verify the equivalence of a third country’s regime: the coordinator or the competent authorities, to which the Mixed Group answered the following:

The competent authority which would be the coordinator is responsible for the verification of the equivalence of a third country’s supervisory regime, according to Article 18(1). Equivalence verification has to be made on a case by case basis for each group, taking into account any guidance issued under Article 18(1) or 29(11).<sup>208</sup>

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206. Financial Conglomerates Directive, *supra* note 1, art. 18(1).

207. Mixed Technical Group, *Implementation and interpretation of Directive 2002/87/EC, Issues Schedule*.

208. *Id.* item 46.

While this answer does not extend much further<sup>209</sup> than what is stated in the relevant provision of the Directive, the idea that equivalence is to be determined for each group was not apparent from the provision's wording. One may ask why this is being done on a group-by-group basis instead of by country or by regulatory framework. One possible answer would be that, as groups may vary in terms of the financial activities in which they are engaged, or at least in the percentage of each activity, as well as in the regulatory frameworks to which they are subject in their home country, regulators are trying to take this into consideration in evaluating equivalence. Moreover, these frameworks may be composed, at least to some extent, of specific measures such as no-action letters or the like, which could only be dealt with on a firm-by-firm basis. In other words, financial conglomerates would be too few and too special to apply a one-size-fits-all approach. Another possible explanation is that some equivalence requirements that are not fully satisfied by the home country regulation could be achieved by negotiation between the coordinator and the concerned group.<sup>210</sup> This could also be the case irrespective of any gap in the home country regulatory framework. Indeed, coordinators may want to negotiate with each group in order to get information they could hardly access otherwise, even through the channels of international regulatory cooperation. In this respect, negotiating on an individual basis would provide regulators with additional bargaining power. Still another possible answer would be that, for political reasons, regulators prefer not to make open judgements on the overall quality of a foreign regulatory framework.<sup>211</sup>

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209. Note however that item 47 addressed a far more detailed question with bearing on this point:

Question: Should activities of third country groups, in or outside the [European Union], be taken into account for the calculation of ratios and the identification of the coordinator of E.U. sub-groups of such third country groups?

Answer: For the purposes of identifying the 'coordinator' for a group with a third country parent: activities outside the [European Union] should not be taken into account; activities of E.U. branches of these groups should also not be taken into account; and activities of E.U. subsidiaries should be taken into account.

*Id.* item 47.

210. This argument has been suggested by Professor Hal Scott.

211. This argument has been suggested by Professor Howell Jackson. However, one could argue that the Financial Conglomerates Committee is actually doing

Understandably, at this point all eyes turned to the most affected regulatory agency in Europe, the FSA, which came under increased pressure to clarify its position. Between October 2003 and July 2004, the FSA conducted a consultation process regarding its implementation of the Financial Conglomerates Directive.<sup>212</sup> Respondents included some twenty-seven organizations, some of them acting confidentially, who raised many different issues. On the question of third-country groups, three aspects received the lion's share: the process for determining equivalence; the FSA's policy towards groups not subject to equivalent supervision; and the timetable for making these decisions.<sup>213</sup> In what follows, this section will deal *tour à tour* with each one of these three issues.

Concerning the process for determining equivalence, the FSA discussed the way it intends to implement the Directive in its Consultation Paper and Feedback, chapters 7 and 5 respectively. There is a two-step process going from general assessments of equivalence, in particular by the European Financial Conglomerates Committee (EFCC), to the supervisor's own judgement of the foreign regulatory framework.<sup>214</sup> As was already mentioned, the EFCC in conjunction with the Banking Advisory Committee (BAC) have issued general guidance on the equivalence of the U.S. and Swiss regulatory frameworks respectively. Overall, the EFCC/BAC guidance characterizes the two systems with the following identical phrase: "we are of the view that, on balance, there is broad equivalence in the [U.S./Swiss] supervisory approaches, notwithstanding the caveats noted below."<sup>215</sup> In any case, such guidance is by no means decisive, for "the final determination must have regard for the specific supervisory arrangements in place for each group"<sup>216</sup> and needs only to be taken into account by the FSA,

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its general determinations on a country basis.

212. See FSA's CONSULTATION PAPER 204 (Oct. 2003) and the FEEDBACK TO CP204 (July 2004). This process resulted in introduction of new rules into the Integrated Prudential Sourcebook (PRU) as well as in amendments or additions to the various Interim Prudential Sourcebooks (IPRU (BANK), IPRU (BSOC), IPRU (FSOC), IPRU (INS), IPRU (INV)). For a detailed list of these changes see FSA, *Handbook Notice 35*, July 20 2004, paragraphs 2.12 to 2.18.

213. See FEEDBACK TO CP204, *supra* note 212, at 31.

214. See CONSULTATION PAPER 204, *supra* note 212, at 43-44.

215. *General Guidance Switzerland*, *supra* note 4, at 3; *General Guidance USA*, *supra* note 4, at 3.

216. FEEDBACK ON CP204, *supra* note 212, at 32.



which will reach a final determination "having consulted other relevant authorities involved in the supervision of the group."<sup>217</sup>

In order to make these determinations, the FSA applies four generic criteria derived from requirements set by the Financial Conglomerates Directive: (1) qualitative group supervision; (2) quantitative group supervision; (3) supervisory co-operation/information sharing; and (4) enforcement. Typically, failure to meet the European standards for any of these criteria should result in a determination of non-equivalence for the group in question.<sup>218</sup> As will be seen later on, the main source of tension is probably the third criterion, particularly regarding information sharing among regulatory authorities.

However, one must keep in mind the key difference between "equivalence" and "harmonization." Equivalence should not be interpreted as requiring the same or even similar standards but rather an overall satisfactory level of regulation. Indeed, while equivalence may pursue ultimate goals similar to those sought through harmonization, particularly risk-management and the establishment of an international level playing field, it does not do so by the same means as harmonization. If equivalence does not entail the sharing of the same standards, this does not necessarily mean that it is less demanding than harmonization. One could argue, for instance, that the very fact that harmonization is limited to standard-setting without due regard for supervisory cooperation and practical enforcement makes equivalence more difficult to attain for certain countries.<sup>219</sup> After all, the impact of a particular standard cannot be dissociated from the extent to which it is actually enforced.

In practice, the FSA has already undertaken a considerable number of equivalence determinations, both concerning the five major broker-dealers registered with the SEC as Consolidated Supervised Entities and a number of Financial Holding Companies organized under the GLBA.<sup>220</sup> However, these determinations will remain confidential unless the group itself makes the information public through other channels, and even in such case, the precise reasoning followed by the FSA in its determination may remain unavailable. In any case,

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217. *Id.*

218. *See generally id.*

219. This point will depend on whether harmonization is defined as covering enforcement levels.

220. Hector Sants, Managing Dir., Wholesale & Inst. Mkts., Keynote Address at the FSA SHCOG/SIA Cross Borders Conference: Regulatory Cooperation (Nov. 15, 2005).

two hypotheses are possible. If equivalence is granted, then no new requirements are imposed on the group. Conversely, if the FSA reaches a decision of non-equivalence, then it has some leeway as to the action it can undertake. This leads to the second major issue identified in the consultation process.

The FSA's policy towards groups not subject to equivalent supervision must be assessed against the broad alternatives offered by the Financial Conglomerates Directive itself.<sup>221</sup> Article 18 paragraphs 2 and 3 vest in the coordinator, after consultation with the other relevant competent authorities, substantial powers in setting the requirements applying to such a case.<sup>222</sup> Three remarks are in order here. First, the requirements can be tailored to suit the specific regulatory needs of a particular conglomerate.<sup>223</sup> Second, paragraph 3 leaves open the question of the specific methodologies that could be selected.<sup>224</sup> This was one of the questions identified in the aforesaid *Issues Schedule* established by the Mixed Technical Group with relation to Article 18.<sup>225</sup> More precisely, it was emphasized that further reflection on these "other methods" should not seek to "come up with a restrictive list of alternative methods."<sup>226</sup> The Directive mentions only one such method, namely the costly establishment of a European-based financial sub-holding company which would fall under the normal regulatory framework set by the Directive.<sup>227</sup> Other methods could include applying these same standards by analogy to the third-country-based entity<sup>228</sup> or using techniques found in sectorial regulations, such as "ring fencing" for banking groups.<sup>229</sup> In any case (and this is the third remark) these alternative methods must achieve the regulatory objectives of the Directive and be notified to both the other competent authorities involved and the European Commission.<sup>230</sup> Drawing upon this general framework, the FSA has stated that its approach will be

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221. Financial Conglomerates Directive, *supra* note 1, art. 18(1)-(2).

222. *Id.*

223. *See id.*

224. *Id.* art. 18(3).

225. Mixed Technical Group, *supra* note 207, item 49.

226. *Id.*

227. *See* Financial Conglomerates Directive, *supra* note 1, art. 18(3).

228. *See id.* art. 18(2).

229. Mixed Technical Group, *supra* note 207, item 49.

230. *See* Financial Conglomerates Directive, *supra* note 1, art. 18(3). It is, however, not clear what would be the procedure to verify this latter requirement.

“proportionate to the risk presented by the group concerned”<sup>231</sup> and that any additional measure “will be chosen having regard to the scale, nature and complexity of each group” as well as “discussed with the group concerned.”<sup>232</sup>

As to the applicable timetable, the FSA’s plan was to make the determinations of equivalence for each concerned group before the start of the 2005 financial year. According to Hector Sants, FSA’s Managing Director for Wholesale and Institutional Markets, more than 100 determinations had been undertaken as of November 2005.<sup>233</sup> But, again, these materials remain confidential. Overall, the absence of public complaints by major financial groups suggests nevertheless that the FSA’s flexible approach of equivalence is working satisfactorily. One may, however, wonder how, in an area characterized by confidentiality, the many financial entities concerned can rest assured that they are not being unequally treated. This approach may create tensions not only among non-equivalently regulated entities, but also between these entities and those benefitting from an equivalence determination. In the first case, one can hardly expect that the FSA will develop an entirely tailored approach for each group. Most probably, it is applying a discrete set of “other methods” according to the level of risk associated with each group. Such an approach, which seems reasonable from a practical point of view, may introduce some competitive disadvantages for those groups most heavily regulated. This is all the more so if we acknowledge that political considerations may have some bearing on the determinations of equivalence. For instance, whether a particular standard is being or will be enforced so as to satisfy equivalence will be strongly influenced by the FSA’s perception of the credibility of the regulatory authorities in a given third country. Moreover, even when such authorities have a credible record, such as the Swiss SFBC, political considerations may intervene in the form of linkages, namely the interrelation of concessions of different nature within the framework of a negotiation. One may reply that the FSA operates independently from any specific item in the UK government’s agenda. However, even if we accept this view, one cannot discard the FSA’s (or the SEC’s) own agenda. As discussed next, the issue of information

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231. FEEDBACK ON CP204, *supra* note 212, at 333.

232. *Id.*

233. Hector Sants, Managing Dir., Wholesale & Inst. Mkts., Keynote Address at the FSA SHCOG/SIA Cross Borders Conference: Regulatory Cooperation (Nov. 15, 2005).

exchange provides a good illustration of the extent to which political pressures underlie the apparently disinterested cooperation among regulators in different countries.

#### *D. Equivalence and Information Exchange*

Among the challenges that stand in the way of equivalence determinations, trust is probably the most difficult one. Equivalence requires trust at two main levels. First, regulators must trust that the supervisory standards of other countries are stringent enough to minimize risks. Second, regulators must also trust that such standards will be adequately enforced. While both assessments are difficult, the information required to perform the former is of far easier access than the one necessary to perform the latter. As a matter of fact, knowing the black letter of the regulatory standards in force in one country is hardly informative as to the actual bite of such standards in practice. This requires far more detailed information, which regulators have traditionally been reluctant to share. In the last three decades, however, a number of crises involving the deficient oversight of internationally active financial groups have persuaded regulators to be more cooperative among them.<sup>234</sup> In any case, the very fact that information exchange is taken into account as part of the third criterion to determine equivalence provides an additional argument for why equivalence may indeed be a more practical strategy for real convergence than the mere harmonization of standards.

The regulation of financial conglomerates is one of the areas where international regulatory cooperation has tended to develop in recent years. However, this is not to say that no obstacles remain. As Professor Hal Scott points out regarding the negotiations between the FSA and the SEC over equivalence: “[t]he more difficult issue [seems] to be the extent to which European regulators would have access to SEC information about entities regulated in the United States.”<sup>235</sup> This problem seems more acute with respect to the Swiss regulatory framework. As stated in the EFCC/BAC general guidance on Switzerland: “There are a number of features of the Swiss legisla-

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234. For two recent contributions on this issue see, Ethan B. Kapstein, *Architects of Stability? International Cooperation among Financial Supervisors*, (Bank for International Settlements, Working Papers No.199, 2006), and Cornelia Holthausen and Thomas Ronde, *Cooperation in International Banking Supervision*, (European Central Bank, Working Paper series No. 316, 2004).

235. Scott, *supra* note 8, at 34 (preliminary form).

tive regime that place constraints on the exchange of information with non-Swiss supervisors.”<sup>236</sup> This may conflict with Recital 14 of the Financial Conglomerates Directive, which considers that equivalence can only exist where “third-country supervisory authorities have agreed to co-operate with the competent authorities concerned on the means and objectives of exercising supplementary supervision of the regulated entities of a financial conglomerate.”<sup>237</sup> Albeit expected, the comment was not well received by the SFBC who found it “unjustified,” particularly in the light of its positive cooperation with the FSA.<sup>238</sup> Beyond any regulatory quarrels, the legal framework underlying the extent to which regulatory agencies are authorized to share information with their foreign counterparts is of great importance, not only for the determination of equivalence but more generally for the regulation of multinational activities. Whereas the SEC and the FSA have apparently overcome the main obstacles on this issue, Switzerland may find itself in a more difficult position.

This section will focus on the exchange of information between the FSA and the two most concerned U.S. regulatory agencies, namely the Federal Reserve Board and the SEC. In a recent address on regulatory cooperation, Hector Sants, the FSA’s Managing Director for Wholesale and Institutional Markets, suggested that traditionally it was not the relation with the Federal Reserve Board but that with the SEC that may have involved some gaps.<sup>239</sup> The Federal Reserve

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236. *General Guidance Switzerland*, *supra* note 4, at 4.

237. *Id.* at 1.

238. The cooperation between the FSA and the SFBC is based on two instruments (Exchanges of letters and Memoranda of Understanding) focusing on banking and securities regulation. SWISS FEDERAL BANKING COMMISSION, RAPPORT DE GESTION 114-15 (2004).

239. Hector Sants stated:

One long-standing feature of this co-operation is the extent to which we rely on the work of the Federal Reserve and the OCC in respect of the various U.S. commercial banks operating in the U.K. When the FSA authorises an overseas bank branch (e.g. Citibank) it is granting that authorisation to the whole entity and not just to the U.K. branch. For the FSA to seek to monitor and supervise every aspect of a U.S. bank’s global operations would be extremely resource intensive quite apart from being duplicative and raising difficult jurisdictional issues. We therefore work with the Federal Reserve and OCC to understand the risk profile and challenges facing U.S. commercial banks operating here and we gain considerable reassurance from their role as lead regulators for these entities on a solo and consolidated basis. Our ability to rely on them is

Board has indeed long developed both informal and formal bases for the exchange of information with other regulatory agencies, including regulations implementing the Freedom of Information Act<sup>240</sup> and different soft-instruments.<sup>241</sup> As the primary regulator for Financial Holding Companies it could therefore express confidence as to the results of the equivalence determinations of the entities subject to it.<sup>242</sup> The SEC's situation in this particular regard was, until very recently, quite different,<sup>243</sup> the main issue being the exchange of information

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based on trust built up over a number of years. One traditional gap in our ability to place reliance on the U.S. authorities has been the fact that the SEC did not undertake consolidated supervision for the major U.S. investment banks.

Hector Sants, Managing Director of Wholesale & International Markets, FSA, Keynote Address on Regulatory Cooperation at the Cross Borders Conference (Nov. 15, 2005).

240. See 12 C.F.R. § 261 (2006). See also the Federal Reserve Board's letter on the *Framework for Financial Holding Company Supervision* (SR 00-13 (SUP)), of August 15, 2000 (emphasizing that "[e]ffective financial holding company supervision requires: Strong, cooperative relationships between the Federal Reserve and primary bank, thrift, and functional regulators and foreign supervisors" and stating later that "[t]he Federal Reserve is committed to continuing to work in a constructive and cooperative fashion with all regulators involved in overseeing the activities of FHCs and their bank and nonbank subsidiaries"); Letter from Richard Spilkenkothen, Director, Bd. Of Governors of the Fed. Res. Sys., to The Officer in Charge of Supervision and Appropriate Supervisory Staff at Each Fed. Res. Bank and to Fin. Holding Companies SR 00-13 SUP (Aug. 15, 2000).

241. See, e.g., Statement of Cooperation on the Exchange of Information for the Purposes of Consolidated Supervision, E.C.-Comptroller of the Currency-Bd. of Governors of the Fed. Res. Sys. (Sept. 17, 1999).

242. Speaking before the Committee on Financial Services of the U.S. House of Representatives, Governor Susan Schmidt Bies stated: "We fully expect that U.S. banking organizations will be found to meet the supervision standard of the directive." Susan Schmidt Bies, Member, Bd. of Governors of the Fed. Res. Sys., Testimony on the U.S.-E.U. regulatory dialogue (May 13, 2004).

243. As the FSA's Managing Director, Michael Foot, noted in speech given in 2003:

The SEC is a Federal regulator like the Federal Reserve but, historically, it seems to have been slower than its banking colleagues to internationalise. Also (because of the view it has long taken on consolidated supervision) it has been less willing to take an "all-in" view of the financial groups it deals with.

Michael Foot, Managing Director, British Fin. Servs. Auth., The "Weakest Link"—Regulatory Co-operation in 2003, Speech at the Guernsey Financial Service Commission Seminar on International Co-operation and Exchange of Information,

concerning investment bank groups. However, this obstacle has apparently been eliminated with the signature of Memorandum of Understanding between the SEC and the FSA on March 14, 2006.<sup>244</sup> As suggested by the press *communiqués* made by the two agencies, this understanding is to be interpreted as part of the overall efforts to achieve an equivalent supervision of investment bank groups, particularly of those having opted for CSE status.<sup>245</sup> Thus, the E.U.-U.S. regulatory dialogue is proving to be an effective device to further financial integration, at least as far as equivalence is concerned. Of course, the determinations on equivalence being confidential, this is just a guess, further based on the idea that should equivalence not be granted to one of the major U.S. financial groups, this would have hardly gone unnoticed.

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(June 5, 2003).

244. *Memorandum of Understanding concerning Consultation, Cooperation and the Exchange of Information Related to Market Oversight and the Supervision of Financial Services Firms*, Mar. 14, 2006. The overall legal basis governing the exchange of information by the SEC is Section 24(c) of the Securities Exchange Act of 1934 (15 U.S.C. § 78x(c) (2006)) and Rule 24c-1 thereon.

245. From the SEC side, Chairman Cox stated that:

The additional tools for information exchange that we will gain from this arrangement will enhance our mutual ability to oversee the world's largest securities firms and markets. This arrangement also facilitates the SEC's new role as a consolidated supervisor of globally active U.S. investment banks. The information sharing arrangements we are formalizing today will help insure that the SEC's supervision of these firms is as effective as possible.

The Director of the SEC's Office of International Affairs, Ethiopis Tafara, also noted that:

In view of the growing globalization of the world's financial markets and the proliferation of globally active financial services firms, including large complex financial conglomerates, establishing and maintaining strong relationships and cooperative efforts with our counterparts in the area of supervision and oversight, in addition to enforcement, is becoming equally important.

SEC Press Release 2006-36 (Mar. 14, 2006). The remarks of the FSA's Chief Executive, John Tiner, were of a more general nature:

This arrangement builds upon the existing framework for exchanging information between our two institutions, when this is necessary, as part of our day to day supervision of firms operating in both the [United States] and [United Kingdom]. We already work closely with the SEC; this [memorandum of understanding] will facilitate that process by setting out the basis on which we will do this.

FSA Press Release (FSA/PN/018/2006) (Mar. 14, 2006).

Now turning to the case of Switzerland, the situation is considerably more complex. Indeed, despite the existence of a number of soft instruments on information exchange with the FSA,<sup>246</sup> the Federal Reserve Board<sup>247</sup> and the SEC,<sup>248</sup> the legal framework in Switzerland is still reluctantly perceived by foreign authorities.<sup>249</sup> Swiss regulators are very much aware of this. In a conference given in June 2002, Daniel Zuberbühler, the Director of the SFBC's Secretariat, noted indeed that: "the exchange of customer-related information between securities regulators by way of international administrative assistance . . . is by far the most serious and urgent issue . . . . It concerns all banks and securities firms in Switzerland . . . ." <sup>250</sup> Although the level of co-operation may have increased to some extent, as claimed by the SFBC in its aforementioned report, the legal framework underlying it remains stringent. These constraints stem from four federal statutes, namely the Federal Banking Act (FBA),<sup>251</sup> the Stock Exchanges and Securities Trading Act (SESTA),<sup>252</sup> the Investment Funds Act (IFA),<sup>253</sup> and the already discussed Act on the Supervision of In-

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246. The SFBC and the FSA maintain soft arrangements, either exchanges of letters or Memoranda of Understanding, with respect to banking and securities regulation. See <http://www.ebk.admin.ch/ff/internat/mous.html> (last visited Nov. 24, 2006).

247. The SFBC and the Federal Reserve Board have issued ad hoc declarations concerning on-site visits. See <http://www.ebk.admin.ch/ff/internat/mous.html> (last visited Nov. 24, 2006).

248. The SFBC and the SEC have exchanged unilateral letters on this issue. See *Conventions avec les Autorites de Surveillance Etrangères*, <http://www.ebk.admin.ch/ff/internat/mous.html> (last visited Nov. 24, 2006). According to the SEC staff, there also existed an MOU as of November 2004. The United States and Switzerland have also concluded a bilateral treaty on mutual legal assistance (MLAT) dated May 25 1973 (RS 0.351.933.6). Treaty on Mutual Assistance in Criminal Matters with Related Notes, U.S.-Switz., May 25, 1973, 27 U.S.T. 2019.

249. See *General Guidance Switzerland*, *supra* note 4, at 4.

250. Daniel Zuberbühler, Director of the Secretariat of the Swiss Federal Banking Commission, *Regulatory Challenges for Swiss Banking Secrecy* (June 21, 2002), available at <http://www.ebk.admin.ch/e/archiv/2002/pdf/neu05e-02.pdf> (last visited Apr. 10, 2006). In this conference, the speaker also acknowledged that the legal framework restraining the exchange of information was "fundamentally flawed and unsuitable for international cooperation in the area of market regulation." *Id.*

251. See Articles 23 *sexies* and 23 *septies* of this Act (*Loi fédérale du 8 novembre 1934 sur les banques et les caisses d'épargne*, RS 952.0).

252. See Article 38 of this Act (*Loi fédérale du 24 mars 1995 sur les bourses et le commerce des valeurs mobilières*, RS 954.1) [hereinafter SESTA].

253. See Article 63 of this Act (*Loi fédérale du 18 mars 1994 sur les fonds de*



insurance Undertakings (LSA).<sup>254</sup> Three main conditions must be satisfied for the SFBC to communicate non-public information to a foreign regulator:<sup>255</sup> the foreign regulator must use the information for the purposes of overseen banks or other financial intermediaries requiring authorization (specialty principle); it is subject to official or professional secrecy (confidentiality principle); and retransmission by the foreign regulator to other authorities is only possible upon prior consent of the SFBC or if authorized by treaty (long arm principle). In all events, the information cannot be given to criminal authorities unless the conditions for mutual assistance in criminal matters are met.<sup>256</sup> Moreover, when the information requested relates to particular clients, these latter institutions must be offered the opportunity to challenge the decision of the SFBC before the Swiss Federal Court, which has admitted the appeals in several cases.<sup>257</sup>

This framework represents a considerable obstacle to international regulatory cooperation with Switzerland. A good illustration of this point is provided by a Swiss Federal Court's decision of December 20, 2001<sup>258</sup> granting an appeal against an information request by the SEC in an insider trading case. The court admitted the appeal, stating that

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*placement*, RS 951.31).

254. See Article 81 of this Act (*Loi fédérale sur la surveillance des entreprises d'assurance*, RS 961.01, in force since January 1 2006).

255. Article 23 *sexies* paragraph 2 of the FBA. See LOMBARDINI, *supra* note 199, at 88-89. The requirements of the Articles 63 IFA and 81 LSA are similar. As discussed later on, those of Article 38 SESTA have changed.

256. In particular are the condition of dual criminality and some tax exceptions. See Zuberbühler, *supra* note 249, at 3.

257. Between 1997 and 2002, twenty-one foreign regulators have submitted 228 information requests concerning approximately 700 clients. The SFBC issued 118 formal decrees of which seventy-three were appealed to the Federal Court, which partially or fully granted these appeals in thirty-four cases. Conversely, the SFBC had addressed until that point only fifteen requests to seven different foreign supervisors. See Zuberbühler, *supra* note 250, at 4-5. Apparently, this is peculiar to Switzerland. See ANNETTE ALTHAUS, AMTSTHILFE UND VOR-ORT-KONTROLLE 79 (2001) (cited in LOMBARDINI, *supra* note 199, at 714). It is up to the SFBC to decide whether the information concerns a client or not. In the asset management area the exchange of information related to clients is even more protected.

258. Bundesgericht [BGer] [Federal Court] Dec. 20, 2001, Pra. 349 Entscheidungendes Schweizerischen Bundesgerichts [BGE] 2A (Switz.). See Zuberbühler, *supra* note 250, at 5; see also Press Release, SFBC, SFBC Opting for modification of legislation on granting administrative assistance to foreign regulators of capital markets (Jan. 23, 2002). The case at issue concerned insider trading before a public take-over bid of ABB for Elsag Bailey. *Id.*

the SEC had not offered enough guarantees regarding confidentiality and specialty, adding nevertheless that the path of international judicial assistance could still be tried.<sup>259</sup> This path, far more cumbersome, was in fact tried and the SEC's request was eventually granted in March 2006.<sup>260</sup> This leaves a mixed impression as to the extent the Swiss regime may achieve equivalence in practice. For international cooperation to be useful, the exchange of information should be operated much faster than it was in this case. On the other hand, Swiss banks tend to see client confidentiality as one of their major comparative advantages, and the Swiss economy overall heavily depends upon the international competitiveness of Swiss banks. This cumbersome procedure has been, in any case, strongly criticized, even by Swiss regulators.<sup>261</sup> In the aforesaid conference, Daniel Zuberbühler made a strong case for the amendment of Article 38 SESTA, a case that has apparently been heard by the law-makers.<sup>262</sup>

Indeed, the situation seems now to be undergoing some important changes. In February 2006, an amendment of Article 38 SESTA entered into force, considerably relaxing the conditions under which the SFBC can grant information requests regarding market oversight.<sup>263</sup> In particular, it allows foreign regulators to retransmit the information to other authorities, including courts using public procedures, without the SFBC's consent, insofar as the information is used for the implementation of markets and securities regulations.<sup>264</sup> This breakthrough is only relevant in the context of SESTA. The other major articles constraining the exchange of information, namely Article 23 *sexies* FBA and Article 63 IFA, have not undergone any significant change in the last few years, while Article 81 of the newly enacted LSA has followed their model. In this context, one may wonder how the amendment of Article 38 SESTA is related to equivalence. Although the explicative note proposing this amendment does not refer in particular to the equivalence issue, it suggests that the amendments pro-

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259. *Id.*

260. *See* Bundesgericht [BGer] [Federal Court] Mar. 9, 2006, Pra. 12 Entscheidungendes Schweizerischen Bundesgerichts [BGE] 1A (Switz.) (rejecting an appeal against the decision of the U.S. desk of the Swiss Federal Office of Justice, dated February 13, 2003, granting the SEC's request).

261. *See* Zuberbühler, *supra* note 249.

262. *Id.*

263. *See Message concernant la modification de la disposition sur l'assistance administrative internationale de la loi fédérale sur les bourses et le commerce des valeurs mobilières*, Nov. 10, 2004, FF 2004 6341).

264. SESTA, *supra* note 252, art. 38(2).

posed are largely a response to significant foreign pressures to render the Swiss framework on this specific area compatible with international needs.<sup>265</sup> Compatibility does not, of course, mean harmonization. The space between these two concepts is perhaps the “natural element” of equivalence as a strategy for convergence.<sup>266</sup> Swiss national susceptibilities are extremely apparent in matters related to banking or financial secrecy,<sup>267</sup> and any amendment to the existing laws requires the consent, at least tacit, of the Swiss people.<sup>268</sup> In this respect, equivalence may be better suited to achieve a compromise than the less flexible idea of harmonization.

### CONCLUDING REMARKS

This study has explored two claims. The first sought to demonstrate that equivalence constitutes in its own right a *feasible* strategy for financial integration in the short, medium, and even long run. The recent developments in the international regulation of financial conglomerates in the European Union, the United States, and Switzerland suggest that such a strategy is working. The second claim is of a more hypothetical nature. In this regard, this article only suggests that equivalence may be a *better* strategy than harmonization, at least in some areas. Of course, one cannot draw this conclusion from the analysis of a single case-study. However, the regulation of financial conglomerates does raise some of the major issues that efforts towards transatlantic or international financial integration will need to tackle. Against this background, this article will briefly come back to the reasons why this hypothetical claim seems reasonable. Three main reasons have been advanced in this respect: that equivalence leaves more leeway for regulators to reconcile the sometimes competing goals of prudential oversight and international competitiveness; that equiva-

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265. *Id.* § 1.5. See generally *id.* §§1.4.1.-1.4.4.

266. The word “compatible” is expressly used. *Id.* § 1.5.

267. See Zuberbühler, *supra* note 249, at 1. Zuberbühler’s very first words in his above cited conference were: “I will have to start with a few disclaimers in order to avoid any misunderstanding before entering into *the sacred ground of Swiss banking secrecy* from a supervisory perspective” (emphasis added). *Id.*

268. In Switzerland, federal laws (or amendments thereon) are subject to a facultative referendum. This means, basically, that when people disagree with the amendment project that has just been approved by the federal legislature there is a period of time within which they can gather a given number of signatures to request a referendum on the project. If the number is attained, then the referendum is held and Swiss citizens vote to approve or reject the project.

lence better accommodates country specificities; and that equivalence better takes into account the enforcement dimension of regulation.

The first reason was examined in light of the recent interactions between the European Union and the United States regarding the supervision of investment bank groups. The detail of these interactions suggests that considerations of international competitiveness may have played a substantial role, despite the fact that E.U. policy-makers mostly referred to prudential considerations. In this context, the equivalence strategy gave American regulators enough leeway to find a solution adapted to their own goals and country specificities. Until very recently, the SEC had not considered it necessary to regulate investment banks at the group level, at least not from a prudential perspective. If it is now doing so, it is largely in response to the Financial Conglomerates Directive and mostly on the basis of considerations of international competitiveness. At the same time, the SEC has limited the impact of the new CSE framework by making it available to only a very few investment bank groups, the major international players. From this point of view, the CSE framework can be interpreted as a balanced compromise between the SEC's own assessment of the lower prudential risk entailed by investment bank groups, and their international competitiveness. Harmonization would have hardly been feasible in this regard, given the substantial differences in the regulatory approaches used in the European Union and United States, particularly with respect to prudential oversight. This latter point leads to the second reason.

Indeed, if the European Union and the United States differ in their prudential assessment of investment bank groups, it is largely because regulation in these jurisdictions has followed very different paths. In most E.U. countries, banking activities were not segregated from the securities business. "Universal Banks" were active in both sectors. Conversely, after the 1929 financial crisis, the banking and securities areas were separated in the United States. Accordingly, the supervisory frameworks applied in each case rested on different goals, which translated into different regulatory techniques or approaches. This feature is but one among many other country specificities. Another possible illustration is provided by the peculiarities surrounding Swiss banking secrecy and its corollaries in the context of international regulatory cooperation. In this regard, equivalence appears more suited than harmonization for legislatures and regulators to tailor supervisory frameworks to the specificities of their countries while ensuring a minimum prudential level.

The third reason is closely related to the second. Indeed, if country specificities cannot be fully taken into account by harmonized regulatory standards, then one may reasonably expect that what was not incorporated in the black letter law may nevertheless be achieved by simply applying these standards differently. From this perspective, a situation in which two different standards are properly applied in their respective jurisdictions may well yield better overall results than the same standard unevenly applied. The uncertainty, or even arbitrariness, that could result from this latter situation would make it particularly undesirable. In this context, the fact that adequate enforcement is one of the four criteria of equivalence makes it a more pragmatic approach than mere harmonization, for which no such component is required.

These three reasons provide a plausible argument for equivalence to be taken seriously. One could further add that, whatever the relative merits of equivalence compared to harmonization, it is in all events a safe first step towards convergence, whether as an autonomous strategy or as one preparing the ground for real, as opposed to formal, harmonization. Although harmonization could also provide, arguably, such a first step by bending the behavior of economic actors in certain ways, it is doubtful a whole financial system may be that docile. At some point reality must be taken into account. In the quest for financial integration, a leap forward can hardly be accomplished if regulatory standards are not sufficiently mindful of the realities to be regulated.

