Dodd-Frank: Regulating Systemic Risk in the Offshore Shadow Banking Industry

Alexander Goodenough*

Introduction

The shadow banking industry consists of entities that are not traditional banks, but yet perform bank-like functions.[1] Shadow banks include some hedge funds, private equity funds, and a variety of nontraditional financial vehicles.[2] Estimates vary concerning the exact size of the global shadow banking sector,[3] but there is some agreement that problems in shadow banking can quickly translate into systemic problems in the traditional banking sector.[4]

In a politically-stated attempt to counter the threat of future crashes caused or exacerbated by systemic risks to the financial system, the United States recently enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[5] This act expands the reporting requirements for investment advisers, defined to include those who manage

∗ J.D. Candidate 2012, George Mason University School of Law. The author would like to thank Mr. Paget-Brown for his helpful comments on an earlier draft. Any errors are those of the author.

1 FINANCIAL SERVICES AUTHORITY [FSA], THE TURNER REVIEW A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS, 21 (2009), *available at* http://www.fsa.gov.uk/pubs/other/turner_review.pdf [hereinafter THE TURNER REVIEW].

2 Kenneth W. Dam, *The Subprime Crisis and Financial Regulation: International and Comparative Perspectives*, 10 CHI. J. INT'L L. 581, 605-06 (2010).

3Manmohan Singh & James Aitken, *The (sizable) Role of Rehypothecation in the Shadow Banking System* (Int'l Monetary Fund [IMF] Working Paper No. 10/172, July 2010), *available at* http://www.imf.org/external/pubs/cat/longres.cfm?sk=24075.0.

4 FSA, ASSESSING POSSIBLE SOURCES OF SYSTEMIC RISK FROM HEDGE FUNDS, at 3 (2010), *available at* http://www.fsa.gov.uk/pubs/other/hedge_funds.pdf [hereinafter ASSESSING POSSIBLE SOURCES OF SYSTEMIC RISK FROM HEDGE FUNDS].

5 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

shadow banks.[6] The Dodd-Frank Act in Title IV expands the reporting requirements by amending the Investment Advisers Act of 1940 to eliminate the private adviser exception and replace it with the foreign private adviser exemption.[7] The extremely narrow nature of the new foreign private adviser exception means that many foreign investment advisers with little professional contact with the United States will be caught within the reporting requirements of the act.[8]

This article begins with a background consideration of the origins of the 2007 financial crisis and its impact on financial markets around the globe. Part I(a) introduces shadow banks and discusses their possible benefits to the financial system along with their demonstrated weaknesses. Part I(b) considers the role offshore financial centers play in the world financial system. Part I(c) discusses the problem of systemic risk and considers its sources. Part II(a) discusses past regulation and attempts at regulation of shadow banks in the United States. Part II(b) introduces the new reporting requirements of the Dodd-Frank Act and considers whether they have extra-territorial scope. Part II(c) analyzes the meanings ascribed by the SEC to certain key phrases in the Dodd-Frank Act in order to determine the scope of the Act's reporting requirements. Part III(a) discusses reasons why international cooperation will be necessary to control systemic risk. Part III(b) analyzes current and past international cooperation and information sharing agreements. Part IV considers the contemporaneous development of systemic risk regulation in the European Union and compares it with that of the Dodd-Frank Act. Finally, Part V discusses the nature of international cooperation necessary to enable systemic risk regulation of the shadow banking sector.

Background:
Origins and Consequences of 2007 Financial Crisis

There are many factors that set the stage for the 2007 financial crisis: macro-economic imbalances, financial innovation, rapid growth, increasing leverage, over-reliance on complex financial models, and hard-wired procyclicality in the financial system.[9] While these set the stage, the

6 § 404, 124 Stat. at 1571-72.

7 § 403, 124 Stat. at 1571.

8 *See* § 402(a), 124 Stat. 1570.

9 *See* THE TURNER REVIEW, *supra* note 1, at 11-25. Procyclicality refers to the tendency to exacerbate rather than retard the effects of the business cycle.

triggering event of the crisis was a collapse of confidence in the asset backed security ("ABS") market caused by doubts about the quality of the packages of mortgages that were the underlying assets.[10] This resulted in a sudden freezing of a previously liquid market.[11] Traditional banks found themselves unable to sell the assets they had been securitizing and therefore were left with these assets on their balance sheets.[12] Confidence in the wider commercial paper market rapidly deteriorated making it impossible for certain institutions to re-finance their debt.[13] These factors combined meant that both traditional and shadow banks could neither continue to finance their balance sheets nor reduce them by selling assets.

In the United States this lack of liquidity combined with falling asset prices claimed two of Bear Stearns' hedge funds and then necessitated a rescue of the entire bank itself.[14] The process snowballed with the Lehman Brothers bankruptcy and a government bailout of American International Group.[15] The panic filtered down to the level of retail depositors, resulting in runs and causing the failures of Washington Mutual and IndyMac even though those banks were not dependent on the credit markets for funding.[16]

In the United Kingdom the disappearance of the market for securitized assets along with a lack of liquidity in the commercial paper market claimed Northern Rock, Bradford & Bingley, and HBOS, thus requiring government intervention.[17] Retail withdrawals in the United

---

10 *See, e.g.*, THE TURNER REVIEW, *supra* note 1, at 25; Gertrude Tumpel-Gugerell, Member of Exec. Bd. of the European Cent. Bank, Introductory remarks at the European Central Bank workshop on recent advances in modeling systemic risk using network analysis (Oct. 5, 2009), *available at* http://www.ecb.int/press/key/date/2009/html/sp091005_1.en.html; Dam, *supra* note 2, at 605-06.

11 *See* THE TURNER REVIEW, *supra* note 1, at 27.

12 THE TURNER REVIEW, *supra* note 1, at 35.

13 *See* THE TURNER REVIEW, *supra* note 1, at 27.

14 THE TURNER REVIEW, *supra* note 1, at 27; Mark Pittman, *Bear Stearns Fund Collapse Sends Shock Through CDOs*, BLOOMBERG, June 21, 2007, *available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ahWfhEJ7dra4.

15 *See* THE TURNER REVIEW, *supra* note 1, at 27.

16 *See id.* at 95.

17 *See id.* at 27.

Kingdom claimed Icelandic bank Landsbanki, forcing international cooperation to ensure that deposit insurance obligations were met.[18] Traditional banks in many other countries also suffered significant losses because of their purchase of securitized instruments.[19]

Worldwide, mandatory capital requirements at traditional banks forced those institutions to hoard cash as falling asset prices threatened their balance sheets.[20] The resulting lack of commercial lending then transmitted the crisis from the financial to the nonfinancial economy, as businesses found it difficult to raise financing or had their existing credit lines withdrawn or reduced.

Part I(a): The Nature of Shadow Banks

The phrase "shadow banking" is perhaps an unfortunate one as it suggests an industry involved in shady dealings. However, shadow banking merely refers to the fact that this industry performs many of the same functions of the traditional banking industry, such as maturity and liquidity transformation, but differs in that shadow banks do not accept deposits.[21] Instead, shadow banks rely on the credit markets for funding. For instance, the now notorious structured investment vehicles ("SIVs") enabled maturity transformation similar to that of banks borrowing short and lending long.[22] SIVs did this by using very short term borrowing to facilitate the purchase of longer maturity assets.[23]

However, SIVs enabled traditional banking institutions to conceal off balance sheet the risks they were taking.[24] Those risks arose because, while a traditional bank that created an SIV might have sold the equity in the SIV, the equity holders may have retained a right effectively to return

18 *See id.* at 38.

19 *See id.* at 36.

20 *Id.* at 59.

21 *Id.* at 21.

22 *Id.* at 21.

23 *Id.* at 21.

24 *Id.* at 20.

the assets of the SIV to the bank if things went wrong.[25] Thus, SIVs earned their notoriety when they suffered enormous losses during the crisis, and traditional banks were forced to move those liabilities back onto their balance sheets.[26]

Therefore, some shadow banks were effectively branches of traditional banking entities, which were already subject to extensive regulation,[27] but poor regulatory oversight enabled traditional banks to use shadow banking entities to conceal off balance sheet the risks they were taking.[28] Also, the complicated nature of the securitized assets held by these shadow banks made it particularly difficult to assess their risk.[29] This process hindered the ability of investors and regulators to judge the risks to which traditional banks were exposed.[30] The Dodd-Frank Act addresses in the Volcker Rule the problems caused by the use of shadow banks by traditional banks.[31] This rule forbids traditional banks from having certain proprietary trading operations such as those often conducted through shadow banks.[32] Thus, the rule may have closed an important channel for systemic risk transfer between the traditional and shadow banking sectors.

Notably, certain hedge funds can fall within the definition of shadow banks. Good examples of how hedge funds can operate as shadow banks are the two Bear Stearns funds that failed at the beginning of the 2007 crisis. Those funds were invested in collateralized debt obligations ("CDOs"), which were packages of securitized mortgages.[33] That investment was financed by loans and credit lines from other banking

---

25 *See id.* at 20.

26 *See id.*at 20.

27 *See* Dam, *supra* note 2, at 612-17.

28 THE TURNER REVIEW, *supra* note 1, at 43.

29 Dam, *supra* note 2, at 615-16.

30 THE TURNER REVIEW, *supra* note 1, at 43.

31 *See* İnci Ötker-Robe and Ceyla Pazarbasiogluat, *Impact of Regulatory Reforms on Large Complex Financial Institutions* 24 (IMF Staff Position Note No. 10/16, 2010).

32 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619, 124 Stat. 1376, 1620-31 (2010).

33 *See* Pittman, *supra* note 14.

institutions, including Merrill Lynch, Goldman Sachs, JPMorgan Chase, and Bank of America.[34] The hedge funds failed when declining prices in the CDO market caused those funds' creditors to call in their loans.[35] While many hedge funds do not fall within the definition of shadow banks because they do not perform large scale liquidity transformation,[36] the Volker rule might have the effect of increasing the number of hedge funds that do operate as shadow banks.[37] The exclusion of traditional banks from this market will provide an opportunity for hedge funds to expand in this area.[38]

Part I(b): Offshore Financial Centers and Shadow Banks

Offshore Financial Centers ("OFCs") are generally geographically small jurisdictions characterized as having economies with disproportionately large financial sectors, which are geared to handling transactions for nonresidents.[39] Together, a few OFCs are home to a significant portion of the world's shadow banking industry. For instance, the Cayman Islands alone are the domicile of almost 40% of the world's hedge funds.[40] Thus, despite their geographically small size, OFCs are very important to the world's financial system.

There are two primary reasons shadow banking entities may choose to incorporate offshore: taxation and regulation.[41] OFCs tend to have much

34 Pittman, *supra* note 14.

35 Pittman, *supra* note 14.

36 THE TURNER REVIEW, *supra* note 1, at 72.

37 *See generally* Ötker-Robe & Pazarbasiogluat, *supra* note 31, at 26.

38 *Id.*

39 *See* U.S. GOV'T ACCOUNTABILITY OFFICE [GAO], GAO-08-778, CAYMAN ISLANDS 6-7 (2008) [hereinafter GAO, CAYMAN ISLANDS]. *See also* IMF, Monetary and Exch. Affairs Dep't, *Background Paper: Offshore Financial Centers*, at 9, (2000), *available at* http://www.imf.org/external/np/mae/oshore/2000/eng/back.htm#I.

40 CHARLES RIVER ASSOCIATES, IMPACT OF THE PROPOSED AIFM DIRECTIVE ACROSS EUROPE 19 (2009), *available at* http://www.fsa.gov.uk/pubs/other/Impact_of_AIFM_Directive.pdf [hereinafter IMPACT OF THE PROPOSED AIFM DIRECTIVE ACROSS EUROPE].

41 Financial Stability Forum [FSF], *Report of the Working Group on Offshore Financial Centers*, at 9 (2000), *available at* http://www.financialstabilityboard.org/publications/r_0004b.pdf. *See also* GAO, CAYMAN ISLANDS, *supra* note 39, at 6.

lower levels of taxation on investment income than traditional onshore centers.[42] Historically, regulation has not been a major reason for shadow banks to incorporate offshore, since domestic regulation was minimal or non-existent. This may change with the stricter reporting requirements of the Dodd-Frank Act.

Shadow banks are valuable to the modern economy because they provide an alternative to maturity and liquidity transformation by traditional banks.[43] These entities can play an important role in securitization.[44] Securitization can be beneficial by diversifying the holding of credit risk from traditional banks to a larger set of investors who should in theory be better able to absorb losses.[45] Unfortunately this result was not achieved in the years running up to the 2007 crisis.[46] However, there is no reason why this desirable end cannot be achieved.[47] Indeed this end might have been achieved already but for two factors: the over-leverage used by shadow banks, which forced them to liquidate assets at disadvantageous prices; and the fact that the traditional banks that originated the securitized assets held by the shadow bank retained risk in the event those assets declined in value.[48]

Shadow banks domiciled in OFCs allow advisers in the United States both to compete for funds to manage and to invest globally.[49] Shadow banks' organization in OFCs enhances competitiveness by

---

42 GAO, CAYMAN ISLANDS, *supra* note 39, at 9.

43 THE TURNER REVIEW, *supra* note 1, at 21, 52.

44 SARAI CRIADO & ADRIAN VAN RIXTEL, STRUCTURED FINANCE AND THE FINANCIAL TURMOIL OF 2007-2008: AN INTRODUCTORY OVERVIEW 18 (Banco De Espana Documentos Ocasionales No. 0808, 2008), *available at* http://www.bde.es/informes/be/ocasional/do0808e.pdf; GAO, CAYMAN ISLANDS, *supra* note 39, at 21. *See* Dam, *supra* note 1, at 622-23.

45 THE TURNER REVIEW, *supra* note 1, at 42.

46 THE TURNER REVIEW, *supra* note 1, at 42.

47 *See* IMF, *Global Financial Stability Report* (2006), *available at* https://www.imf.org/external/pubs/ft/GFSR/2006/01/index.htm; Dam, *supra* note 2, at 623-26.

48 *See* Dam, *supra* note 2, at 625-30.

49 GAO, CAYMAN ISLANDS, *supra* note 39, at 16.

reducing double taxation of investment returns.[50] Shadow banks such as hedge funds and private equity funds are considered important alternatives to investors because they provide a means of increasing investment portfolio returns by providing diversification with reduced correlation to other asset classes.[51] Indeed, they also played an important role in resolving the 2007 financial crisis by purchasing distressed assets, thereby providing much needed liquidity to the credit markets.[52] Shadow banks based in OFCs provide an important channel for foreign investment in the United States.[53] Because of the perceived litigation risk, some foreign investors hesitate to invest in the United States directly.[54]

Part I(c): Systemic Risk

Systemic risk is a by-product of the inter-connectedness of the global financial system.[55] Systemic risk may be regarded as being similar to pollution in that it is a negative externality.[56] This externality occurs because investors transacting in the financial markets consider only the risks their transactions pose to them rather than the risks the transactions pose to their creditors, counter-parties, or other third parties. Therefore, systemic stability seems to be a public good to the extent that everyone benefits from it, but no one individually has the incentive to provide it.[57] While there may not be an incentive deliberately to minimize systemic risk individually, protection may be provided as a mere by-product of individuals' desire to avoid losses. As individuals minimize their individual

---

50 GAO, CAYMAN ISLANDS, *supra* note 39, at 30.

51 IMPACT OF THE PROPOSED AIFM DIRECTIVE ACROSS EUROPE, *supra* note 40, at 53-56.

52 *See* Bei Hu, *Hedge Funds Lower Fees*, *Lengthen Lockups on New Funds*, BLOOMBERG, Dec. 3, 2010, *available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=asQ4d66xij2o.

53 GAO, CAYMAN ISLANDS, *supra* note 39, at 19.

54 GAO, CAYMAN ISLANDS, *supra* note 39, at 16.

55 European Central Bank, *Recent Advances in Modelling Systemic Risk Using Network Analysis*, at 6 (2010), *available at* http://www.ecb.int/pub/pdf/other/modellingsystemicrisk012010en.pdf.

56 *Id.* at 5.

57 *Id.* at 6.

risk exposure, they simultaneously provide incentives that minimize systemic risk.[58]

There are two general ways in which systemic risk can spread. The market channel conveys systemic risk when forced asset sales by one or more entities cause market prices for those assets to decline.[59] These declining market prices then trigger further forced sales and cause prices to cascade downward. This process stems from a failure by investors to judge correctly the downside risk of their investment or to hedge this risk correctly. The market channel is particularly dangerous when many investors in a market are using high levels of leverage, because then losses lead quickly to forced sales. The credit channel conveys systemic risk when the failure of an entity causes losses to that entity's creditors that in turn threaten the creditors' financial stability.[60] Credit risk stems from a failure of creditors to judge risk accurately, require adequate security for their loans, and/or to diversify across risks. Credit risk is also more prevalent when high levels of leverage are used because then losses lead more quickly to failures.

As its name suggests, the boundary of systemic risk is determined by the boundaries of the system of which those risks are a part.[61] As the 2007 crisis illustrated, the interconnectivity of the financial system can quickly cause international contagion of financial disturbances.[62] The extent of the risk posed by an individual entity to the international financial system may be judged by the size of the entity and how inter-connected it is with the rest of the financial system, that is, by network analysis.[63] The

58 *See generally* DAVID MAYES, A MORE MARKET BASED APPROACH TO MAINTAINING SYSTEMIC STABILITY (FSA Occasional Paper Series, 2000), *available at* http://www.fsa.gov.uk/pubs/occpapers/op10.pdf (arguing that greater transparency and the possibility of failure would reduce risk taking and strengthen the traditional banking system).

59 ASSESSING POSSIBLE SOURCES OF SYSTEMIC RISK FROM HEDGE FUNDS, *supra* note 4, at 3; IMPACT OF THE PROPOSED AIFM DIRECTIVE ACROSS EUROPE, *supra* note 40, at 79-80.

60 ASSESSING POSSIBLE SOURCES OF SYSTEMIC RISK FROM HEDGE FUNDS, *supra* note 4, at 78-79.

61 *See* IMF, *Global Financial Stability Report*, at 113 (2009), *available at* http://www.imf.org/external/pubs/ft/gfsr/2009/01/pdf/text.pdf.

62 *See* THE TURNER REVIEW, *supra* note 1, at 27.

63 European Central Bank, *Recent Advances in Modelling Systemic Risk Using Network Analysis*, at 6, (Jan. 2010), *available at*

systemic importance of an entity, whether it is a traditional or a shadow bank, may also be judged by looking at its balance sheet.[64] The asset side of the balance sheet will provide information relating to the systemic risk the entity poses through the market channel, while the liabilities side will show which other entities are exposed to risk via the credit channel and the extent of that risk.

Systemic risk is not limited to any particular type of financial institution; both traditional banks[65] and shadow banks can pose systemic risks.[66] The problem in the 2007 financial crisis was that traditional banks did not publicly disclose the risks that they were taking, since those risks were often concealed in off balance sheet shadow banking entities.[67] While some issues can be addressed by regulation of the traditional banking sector, problems remain because many shadow banks do not publicly disclose the information necessary for market participants to judge the systemic risk posed by those shadow banks.[68]

While the shadow banking sector did not itself cause the financial crisis in 2007, it did exacerbate the crisis.[69] Shadow banking institutions had to react very quickly to changes in asset prices and the availability of credit due to the short-term nature of their funding and high levels of leverage.[70] De-leveraging in the shadow banking sector due to the liquidity

http://www.ecb.int/pub/pdf/other/modellingsystemicrisk012010en.pdf; *Global Financial Stability Report*, *supra* at note 61 at 113.

64 *See* Jorge A. Chan-Lau, *Balance Sheet Network Analysis of Too-Connected-to-Fail Risk in Global and Domestic Banking Systems*, (IMF Working Paper WP/10/107, 2010), *available at* http://www.imf.org/external/pubs/ft/wp/2010/wp10107.pdf.

65 *See* THE TURNER REVIEW, *supra* note 1, at 27.

66 *See* REPORT OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG TERM CAPITAL MANAGEMENT, Treas. Rep. No. 3097, at 17-18 (1999), *available at* https://ustreas.gov/press/releases/reports/hedgfund.pdf.

67 *See* THE TURNER REVIEW, *supra* note 1, at 21.

68 *See* Thomas C. Pearson & Julia Lin Pearson, *Protecting Global Financial Market Stability and Integrity: Strengthening SEC Regulation of Hedge Funds*, 33 N.C. J. INT'L L. & COM. REG. 1, 25-31 (2007).

69 *See* THE TURNER REVIEW, *supra* note 1, at 11-25, 27.

70 *Id.* at 21.

crunch led to asset depreciation caused by forced asset sales.[71] Those sales spread risk via the market channel by causing further declining asset prices.[72] Many shadow banks could neither continue to finance their balance sheets because of the credit crunch, nor reduce their balance sheets by asset sales, because asset prices were either very depressed or the market for such assets had ceased to function altogether. Creditors of shadow banks were then faced with losses that threatened their own stability.[73] Uncertainty generated by this sequence of events then caused disruption to the broader commercial paper market.

Part II(a): Past Reporting Requirements in the United States

The Investment Advisers Act of 1940 required that investment advisers register and make their records available to the SEC.[74] However, the reporting requirements contained exemptions that enabled many advisers to avoid having to register or provide information.[75] Most importantly, these exceptions included the private adviser exception.[76] This exemption allowed advisers with fewer than 15 clients to avoid having to report to the SEC at all.[77] The term client referred only to the number of funds managed by the private adviser, rather than counting the individual investors in them.[78] Many important advisers had fewer than 15 separate

71 *Id.* at 22.

72 *See* IMPACT OF THE PROPOSED AIFM DIRECTIVE ACROSS EUROPE, *supra* note 40, at 79-80.

73 *See id.* at 78-79.

74 Investment Advisers Act, 15 U.S.C. § 80b-4 (2006).

75 15 U.S.C. § 80b-3.

76 Amy L. Goodman, *Financial Reform: 2010*, *Working Summary No. 1*, *Washington Report on Financial Institutions*, at 297 (PLI Corp. Law & Practice, Course Handbook Ser. No. 1822, 2010).

77 Investment Advisers Act, 15 U.S.C. § 80b-3(b)(3) (2006) ("The provisions of subsection (a) of this section shall not apply to any investment adviser who… has had fewer than fifteen clients…").

78 Pearson & Pearson, *supra* note 68, at 51-56; Goldstein v. SEC, 451 F.3d 873, 876 (D.C. Cir. 2006). *See also* Definition of "Client" in Investment Adviser for Certain Purposes Relating to Limited Partnerships, *50 Fed. Reg. 8,740 (1985).*

funds and, therefore, were exempt from registration under the act.[79] The SEC attempted to close this loophole by broadening the definition of "clients" in its Hedge Fund Rule.[80]

In 2004 the SEC attempted to narrow the private adviser exception by producing new regulations that redefined "clients" to include "shareholders, limited partners, members or beneficiaries."[81] Thus, every adviser managing funds with more than 15 investors had to register,[82] and after registering, advisers could be required to provide records to the SEC.[83]

The hedge fund rule was challenged in *Goldstein v. SEC* and vacated by the D.C. Circuit.[84] Although the Court acknowledged that the SEC's reading was not foreclosed by the wording of the Advisers Act, the Court held that the SEC's reading of clients was arbitrary and too broad.[85] The D.C. Circuit found that the relationship between advisers and the investors in the funds advised was not sufficiently close to justify treating the investors as clients of the advisers, because investors were not given individualized advice by the adviser.[86] Rather, the court held the adviser had only a uniform fiduciary duty to the fund.[87]

Following *Goldstein*, the SEC tightened regulation of hedge funds concerning only misleading statements to investors.[88] Thus, prior to the

79 *Goldstein*, 451 F.3d at 876.

80 Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054 (2004).

81 *See Goldstein*, 451 F.3d at 877 (quoting 17 C.F.R. § 275.203(b)(3)-2(a)).

82 *See id.* at 874.

83 *See* Investment Advisers Act 15 U.S.C. § 80b-4 (2006).

84 *Goldstein*, 451 F.3d at 884.

85 *Id*.

86 *Id.* at 882-83.

87 *Id.* at 883.

88 Pearson & Pearson, *supra* note 68, at 59 (citing Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, Securities Act Release No. 8766, Investment Advisers Act Release No. 2576, Fed. Sec. L. Rep. (CCH) ¶¶ 84042-43 (Dec. 27, 2006)).

Dodd-Frank Act, many investment advisers to shadow banks were not subject to reporting requirements in the United States.[89]

The United States had previously exempted from regulation shadow banks that only accepted investments from "accredited investors."[90] Accredited investors have been defined by the SEC to include high-net-worth individuals, worth in excess of $1,000,000, and certain entities with assets exceeding $5,000,000.[91] The rationale behind allowing those investors to invest in less regulated shadow banking entities was that, due to their assumed level of sophistication, such investors do not require the protection of the SEC.[92] Sophisticated investors are thought capable of protecting themselves from investing losses and frauds. If this is true, then sophisticated investors should, as a by-product, protect others from systemic risk. This is because if these investors are capable of ensuring that the entities they invest in do not fail, then systemic risk contagion via the credit channel is eliminated. Systemic risk via the market channel is also reduced because these investors will ensure the entities they invest in are appropriately leveraged and not subject to forced sales due to margin calls. Sophisticated investors will seek to avoid margin calls because they force the liquidation of assets, usually at times when the prices of those assets are depressed. Thus, limiting the ability of non-sophisticated investor to invest in shadow banking entities should have tended to increase the effectiveness of market forces in ensuring these entities did not fail, thereby reducing systemic risk.

This theory obviously did not work with shadow banks for Long Term Capital Management ("LTCM") in 1998 or SIVs during the 2007 crisis. Those entities lost their sophisticated investors very large sums of money. However, the market seems to have partially resolved these problems itself. SIVs are now an extinct species.[93] Hedge funds no longer

89 *See* Pearson & Pearson, *supra* note 68, at 49-51.

90 Investment Advisers Act, 15 U.S.C. § 80a-6 (This section has been amended by the Dodd-Frank Act). Strictly speaking non-accredited investors are not excluded from investing in such asset classes but marketing to non-accredited investors triggers registration requirements. Given that such funds wished to avoid those requirements the effect was the same as an outright exclusion.

91 Accredited Investor, 17 C.F.R. § 230.215 (1982).

92 *Cf.* Howard M. Friedman, *On being Rich, Accredited, and Undiversified: The Lacunae in Contemporary Securities Regulation*, 47 OKLA. L. REV. 291, 299 (1994) (arguing that the rich are not in fact as sophisticated in their investment as has been assumed).

93 *See, e.g.*, Paul J. Davies, Anousha Sakoui and Gillian Tett, *Sigma collapse ends shadow*

operate at the same level of leverage as was used at LTCM, and counterparties to hedge funds are now more careful to monitor exposure and require more information about risk-taking by the funds.[94] Thus, investors appear to have altered their behavior to take into account new information regarding the levels of risk posed by certain investing activities, particularly in shadow banking entities.

Part II(b): The Dodd-Frank Act

The Dodd-Frank Act amends the Investment Advisers Act of 1940 by, among other things, eliminating the private adviser exception,[95] and creating the foreign private adviser exception.[96] The Bill also sets up a Financial Stability Oversight Council ("FSOC").[97] Advisers must register with the SEC and may be required to provide systemic risk data to it and the FSOC.[98]

The Supreme Court found in *Morrison v. National Australia Bank Ltd.* that, unless there is specific Congressional indication to the contrary, federal law is interpreted not to have effect outside the United States.[99] In *Morrison* the Supreme Court found that Congress did not intend section 10(b) of the Securities and Exchange Act of 1934 to have extra-territorial application.[100] A similar question may be raised as to whether Congress intended Title IV of the Dodd-Frank Act to have extra-territorial application.

There are two levels at which a statute can be found to have extra-territorial application according to the Supreme Court in *Morrison*: at the

bank project, FINANCIAL TIMES, Oct. 1, 2010, *available at* http://www.ft.com/cms/s/0/19db6e24-8fff-11dd-9890-0000779fd18c.html?nclick_check=1.

94 IMPACT OF THE PROPOSED AIFM DIRECTIVE ACROSS EUROPE, *supra* note 40, at 77-78.

95 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 403, 124 Stat. 1376, 1571 (2010).

96 §§ 402-03, 124 Stat. at 1570-71.

97 § 111, 124 Stat. at 1392-93.

98 § 404, 124 Stat. at 1572.

99 Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869, 2878 (2010).

100 *Id.*

section level,[101] or at the statutory level.[102] Accordingly, the Dodd-Frank Act must be analyzed at both levels to determine whether the act contains an affirmative indication of Congressional intent for extra-territorial application.[103]

Section 10(b) of the Securities and Exchange Act of 1934 governs fraud "in connection with the purchase or sale of any security…"[104] The focus of section 10(b) is on the transaction rather than the parties to it.[105] Section 402 of the Dodd-Frank Act defines the new foreign private adviser exception.[106] The focus of this exception is the person advised rather than any transactions performed or services rendered.[107] The reporting requirement is triggered if the adviser has clients or investors in the United States. Therefore, it seems the term 'foreign private adviser' is intended to have territorial scope as far as the clients or investors being advised are concerned, but, as its name suggests, extra-territorial scope as far as advisers are concerned.

Section 403 of the Dodd-Frank Act amends section 203 of the Investment Advisers Act of 1940 to eliminate the private adviser exception and to replace it with the foreign private adviser exception.[108] So amended, the phrase "investment adviser" will have extra-territorial reach to all foreign advisers who do not fall within the foreign private adviser exception.[109] Unlike section 10(b), [110] section 203(b) will not reach only to

101 *See id.* at 2883 (discussing the clear statement of extra-territoriality in subsection 30(a)).

102 *See id.* at 2882 (discussing how the definition of interstate commerce does not defeat the presumption against extra-territoriality).

103 *See id.* at 2882-83.

104 Securities and Exchange Act of 1934, 15 U.S.C. § 78j(2)(b) (2000).

105 *Morrison*, 130 S. Ct. at 2884.

106 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 402, 124 Stat. 1376, 1570 (2010).

107 *Compare* § 402, 124 Stat. at 1570, *with* Securities and Exchange Act of 1934, 15 U.S.C. § 78j (2000).

108 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 403, 124 Stat. 1376, 1571 (2010).

109 *Id.* (there are other exceptions to the registration requirements but those relate to

transactions in the United States, but will follow the funds of United States clients or investors anywhere in the world. [111] Therefore, amended section 203 has broad international scope by virtue of the narrowness of the foreign private adviser exception.[112]

Section 404 of the Dodd-Frank Act requires investment advisers to provide systemic risk information to the SEC.[113] Other than the extra-territorial reach conveyed to it by its use of the phrase "investment adviser," section 404 does not make reference to the collection of data outside the United States.[114] Thus, the only indication that section 404 was intended to have extra-territorial application is the scope of the exception to it. Whether this would be an affirmative indication of Congressional intent for extra-territoriality is doubtful in light of the narrow statutory reading in *Morrison*. Therefore, it is necessary to consider other sections of the Dodd-Frank Act to determine whether Congress indeed intended the collection of systemic risk data from outside the United States.[115]

Congress certainly anticipated the necessity of gathering information from foreign nonbank financial companies outside the United States in the Dodd-Frank Act.[116] For instance, in order to mitigate the burden of reporting, section 112 provides that the FSOC, whenever possible, will make use of information already collected by foreign regulators.[117] Section

---

activities within the United States).

110 *Morrison*, 130 S. Ct. at 2884.

111 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 403, 124 Stat. 1376, 1571 (2010).

112 *See id*.

113 § 404, 124 Stat. at 1571-72.

114 *Id.*

115 *See Morrison*, 130 S. Ct. at 2884-85.

116 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 102, 124 Stat. 1376, 1391 (2010) (defining a foreign nonbank financial company as a company incorporated or organized in a country other than the United States that is predominantly engaged in financial activities); § 112, 124 Stat. at 1394-95 (the function of the council is to monitor such companies for systemic risks).

117 §§ 112(d)(3)(C), 116(b)(1)(A), 124 Stat. at 1395, 1406.

113 grants the Board of Governors of the Federal Reserve ("the Board of Governors") the authority to determine which foreign nonbank financial companies it should supervise because of the systemic threat posed by those companies to the United States.[118] The Board of Governors is authorized to consider, when making that determination, the regulation these companies are already subject to by foreign supervisory authorities,[119] and to consult with those regulators.[120] Once the Board of Governors has determined it should supervise a company, it is authorized to regulate that company's behavior.[121] All that appears to be necessary is a determination that the company poses a threat to the financial stability of the United States.[122]

Section 175 of the Dodd-Frank Act provides for the cooperation of the FSOC and the Board of Governors with foreign counterparts and governments, international organizations, and multilateral organizations.[123] Sections 929K and 981 facilitate this international coordination by allowing the sharing of privileged regulatory information with foreign supervisory authorities.[124] Section 929J is the sharper end of the stick, in that it requires foreign accounting firms to produce the documents at the request of the SEC or Board of Governors.[125]

Thus, several other sections of the Dodd-Frank Act explicitly provide for the regulation of, and data collection from, foreign entities because of the systemic risk they might pose to the financial system of the United States.[126] Although the aim of the Securities and Exchange Act of 1934 was at least in part to control systemic risk,[127] it seeks to achieve this

118 § 113(b)(1), 124 Stat. at 1398-99.

119 §§ 113(b)(2)(H), 115(b)(2), 124 Stat. at 1399, 1403.

120 § 113(f)(3), -(i), 124 Stat. 1376, 1402.

121 § 121(d), 124 Stat. at 1411.

122 *See* § 113(b), 124 Stat. at 1398-99.

123 § 175, 124 Stat. 1376, 1442 (2010).

124 §§ 929K, 981, 124 Stat. at 1860-61, 1926-27.

125 § 929J, 124 Stat. at 1859-60.

126 *See, e.g.*, § 113(b), 124 Stat. at 1398-99.

127 *See* Securities and Exchange Act of 1934, 15 U.S.C. § 78b(3)-(4) (1975).

through regulation of domestic securities transactions.[128] The Dodd-Frank Act knows no such bounds. Instead the criterion that the Dodd-Frank Act uses to determine its reach is the extent of systemic risk to the United States.[129] Therefore, the SEC is justified in reading Title IV of the Dodd-Frank Act to have extra-territorial scope in its rules.[130]

Part II(c): Foreign Private Adviser Exception

The definition of a "foreign private adviser" requires a foreign based investment adviser with only minimal contacts with the United States to register with the SEC.[131] A foreign private adviser is defined as:

> any investment adviser who--
> (A) has no place of business in the United States;
> (B) has, in total, fewer than 15 clients and investors in the United States in private funds advised by the investment adviser;
> (C) has aggregate assets under management attributable to clients in the United States and investors in the United States in private funds advised by the investment adviser of less than $25,000,000, or such higher amount as the Commission may, by rule, deem appropriate in accordance with the purposes of this title; and
> (D) neither--

128 *See* Securities and Exchange Act of 1934, 15 U.S.C. § 78b(1)-(2) (1975); Morrison v. Nat'l Australia Bank Ltd., 130 S. Ct. 2869, 2884-85 (2010) ("Those purchase-and-sale transactions are the objects of the statute's solicitude. It is those transactions that the statute seeks to regulate.").

129 *See, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 112(a)(1), 113(a)-(c), 121(a), 175, 404, 124 Stat. 1376, 1394-95, 1398-1401, 1410, 1442, 1571-72 (2010).

130 *See* Foreign private advisers, 17 C.F.R. § 275.202(a)(30)-1 (effective July 21, 2011). *See also* Exemption for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $ 150 Million in Assets Under Management, and Foreign Private Advisers, 75 Fed. Reg. 77190 (proposed Dec. 10, 2010) (codified at 17 C.F.R. pt. 275) [hereinafter Exemption for Advisers].

131 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 402, 124 Stat. 1376, 1570 (2010). *See also* Foreign private advisers, 17 C.F.R. § 275.202(a)(30)-1 (effective July 21, 2011). *But see* Chris Brummer, *Post-American Securities Regulation*, 98 CAL. L. REV. 327, 335-36 (2010) (discussing the restraint traditionally shown by the SEC in extra-territorial matters).

> (i) holds itself out generally to the public in the United States as an investment adviser; nor
>
> (ii) acts as--
>
> (I) an investment adviser to any investment company registered under the Investment Company Act of 1940;
>
> or
>
> (II) a company that has elected to be a business development company pursuant to section 54 of the Investment Company Act of 1940 (*15 U.S.C. 80a-53*), and has not withdrawn its election.[132]

The words "in private funds" do not appear in the original private adviser exception.[133] The inclusion of this phrase now indicates that Congress intends the phrase "clients and investors" in this instance to have the meaning the SEC attributed to clients in the Hedge Fund Rule, which was rejected in *Goldstein*. This results in the new foreign private adviser exception being much narrower in scope than the old private adviser exception. The narrowness of the new exception widens the scope of the registration requirements.[134]

There are a number of phrases in the foreign private adviser exception that are not defined in the Dodd-Frank Act. Indeed, the Congressional record is oddly devoid of discussion of the foreign private adviser exemption.[135] Therefore, the SEC has had to promulgate regulations defining those phrases used in the exception with little legislative guidance. This section will consider the definitions the SEC has published in its updated rules for the Investment Advisers Act of 1940 in response to the Dodd-Frank Act,[136] and how those definitions affect the scope of the act.

---

132 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 402, 124 Stat. 1376, 1570 (2010).

133 Investment Advisers Act, 15 U.S.C. § 80b-3(b)(3) (2006).

134 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 403, 124 Stat. 1376, 1571 (2010).

135*See, e.g.*, H.R. Rep. No. 111-517, at 866-67. *See also* Michael I. Overmyer, *Note: The "Foreign Private Adviser" Exemption: A Potential Gap in the New Systemic Risk Regulatory Architecture*, 110 COLUM. L. REV. 2185, 2280 n.164 (2010).

136 Rules and Regulations, Investment Advisers Act of 1940, 17 C.F.R. § 275.

In rule 202(a)(30)-1 the SEC defines as a single "client" a natural person, that person's minor children, relatives or spouse with the same address, and all accounts and trusts of which the first two categories are the sole beneficiaries.[137] Fictional persons such as corporations, partnerships, LLCs, and trusts are also a single client provided that the adviser provides advice only on the basis of the organization's investment objectives.[138] Multiple fictional persons can count as a single client provided those organizations have identical shareholders, partners, limited partners, members or beneficiaries.[139] Double counting is avoided since an organization or private fund is not counted as a client if any investor in it has been already counted.[140] The definition is not entirely clear because of the uncertainty introduced by the question of whether the advice given is solely for the objectives of an organization. The SEC states that whether or not an advisory relationship should be characterized as with a single client must be determined on a case by case basis.[141] This introduces uncertainty as to whether an adviser can count an organization as a single client or must look-through and count the investors in that entity.

Also in rule 202(a)(30)-1 the SEC defines investor as:

> Any person who would be included in determining the number of beneficial owners of the outstanding securities of a private fund under section 3(c)(1) of the Investment Company Act (15 U.S.C. 80a-3(c)(1)), or whether the outstanding securities of a private fund are owned exclusively by qualified purchasers under section 3(c)(7) of that Act (15 U.S.C. 80a(c)(7)); and Any beneficial owner of any outstanding short-term paper, as defined in section 2(a)(38) of the Investment Company Act of 1940 (15 U.S.C. 80(a)(38)), issued by the private fund.[142]

137 Foreign private advisers, 17 C.F.R. § 275.202(a)(30)-1 (a)(1) (effective July 21, 2011).

138 17 C.F.R. § 275.202(a)(30)-1 (a)(2)(i).

139 17 C.F.R. § 275.202(a)(30)-1 (a)(2)(ii).

140 17 C.F.R. § 275.202(a)(30)-1 (b)(5).

141 Exemption for Advisers, *supra* note 130, at 77211 n.231.

142 Foreign private advisers, 17 C.F.R. § 275.202(a)(30)-1 (c)(2) (effective July 21, 2011).

Thus, persons who hold either equity or debt in the private fund would be counted as an investor.[143] The definition of investors looks-through to find the "underlying holders" of private fund issued securities.[144] Therefore, use of nominee or intermediate accounts will not avail an adviser in avoiding the reporting requirements as such structures will be looked through to count individual investors.[145] Similarly, a look-through will be employed to count investors in any entity formed for the specific purpose of investing in a private fund, as investors in that fund.[146] An adviser to a master fund must count as investors the holders of securities in any feeder fund.[147] Also, the holders of certain derivatives based upon the private fund, such as a total return swap, and the holders of short-term paper, less than nine months in duration, fall within the definition of investors.[148] The status of entities that provide margin facilities is not mentioned, but, if so, they would be in a similar position as the holders of short term debt and, therefore, might also be counted as investors. Thus, reaching the $25,000,000 limit for the foreign private adviser exemption is possible without any direct investor in the funds being a U.S. person.

The phrase "in the United States" is defined to conform with the meaning of "U.S. person" under Regulation S.[149] The operative time for determining a person's status is when that person becomes a client or investor.[150] This means that advisers are not required to keep track of the movements of their clients and investors in order to determine whether they have to register. Under Regulation S, a U.S. person includes: any resident of the United States, any corporation or partnership formed under the laws of the United States, any estate of which any executor or administrator is a U.S. person, any trust of which any trustee is a U.S. person, any agency or

143 *Id*.

144 Exemption for Advisers, *supra* note 130, at 77212 n.241.

145 *Id*.

146 *Id*. at 77212 n.244.

147 *Id*.

148 *Id.* at 77212.

149 Foreign private advisers, 17 C.F.R. § 275.202(a)(30)-1 (c)(3)(i) (effective July 21, 2011).

150 § 275.202(a)(30)-1 note to paragraph(c)(3)(i).

branch of a foreign entity located in the United States, and partnerships or corporations formed by natural U.S. persons in foreign jurisdictions for the purpose of investing in unregulated securities.[151] Discretionary accounts owned by U.S. persons are also treated as U.S. persons.[152] So far the foreign subsidiaries of US corporations that qualify as accredited investors are not designated as U.S. persons.[153] As it will be difficult to categorically distinguish foreign subsidiaries set up to avoid the reporting requirements from those set up for normal business purposes, the SEC will probably designate foreign subsidiaries as U.S. persons on a case by case basis to prevent the use of foreign subsidiaries to avoid the reporting requirements.

A place of business is defined to be any office where the investment adviser regularly provides advisory services, solicits, meets with, or otherwise communicates with clients, and any location held out to the public as a place where the adviser conducts any such activities.[154] Thus, merely having a trading office in the United States is not enough to qualify as having a place of business in the United States. This narrow definition of a place of business will help reduce the potential negative effect the reporting requirements could have of reducing the participation of foreign investment advisers in the United States' capital markets by enabling such advisers to continue to have offices in the United States for trading or other management purposes.

The SEC has defined "assets under management" by reference to regulatory assets under management as calculated for Item 5 of Form ADV.[155] Item 5 of Form ADV requires that an adviser include in the value of assets under management the full value of any portfolio, including securities purchased on margin, that is greater than 50% invested in securities.[156] Securities are defined to include cash and cash equivalents.[157]

151 Regulation S -- Rules Governing Offers and Sales Made Outside the United States Without Registration Under the Securities Act of 1933, 17 C.F.R. § 230.902(k) (2005).

152 17 C.F.R. § 230.902(k)(vii).

153 17 C.F.R. § 230.902(k)(viii).

154 Foreign private advisers, 17 C.F.R. § 275.202(a)(30)-1 (c)(3)(ii) (effective July 21, 2011) (citing 17 C.F.R. § 275.222-1(a)).

155 17 C.F.R. § 275-203A-3(d).

156 17 C.F.R. § 279.1.

157 SEC, Form ADV: General Instructions, at 17, *available at*

Non-securities include collectables, commodities and real estate.[158] Thus, some advisers may be able to avoid reporting by altering the proportion of asset classes held by the funds they manage.

The SEC interprets the term advisers to include subadvisers; therefore, the exemptions to the registration requirements are available to subadvisers who meet all the criteria for the exemption.[159] Mere existence as separate legal entities is not sufficient; rather, the two entities must be operated independently.[160] This will have to be determined on a case by case basis.

The SEC seems to have closed the most obvious methods of structuring investments to avoid reporting requirements, particularly with its inclusion of extensive look-through provisions in its definition of investor.[161] But from the point of view of regulating systemic risk, a few points of concern remain. The first point of concern regards the foreign subsidiaries of U.S. non-natural persons, which qualify as accredited investors. Such foreign subsidiaries are not considered to be U.S. persons themselves. Not only does it open a potential avenue for circumvention of the reporting requirements, but it also leaves open an important avenue of systemic risk as the losses of a foreign subsidiary could threaten the stability of the U.S. parent. Second is the fact that holders of debt of maturity longer than nine months are not counted as investors. From the systemic risk point of view, long-term debt holders are not obviously in a better position than short-term debt holders should the debtor default; both are at risk of contagion of systemic risk through the credit channel. Perhaps it is unusual for debt with duration of more than nine months to be unsecured. Whatever the reason for the distinction, this avenue for systemic risk contagion remains outside the reporting requirements. Third, and most importantly, Title IV of the Dodd-Frank Act does not address an important aspect of international systemic risk via the market channel. This is

---

http://www.sec.gov/about/forms/formadv-instructions.pdf.

158 *Id.* at 19.

159 *See* Exemption for Advisers, *supra* note 130, at 77214.

160 *Id*.

161 The author readily admits that he is not an expert in finding loopholes in securities regulation and has no doubt that legal advisers much more ingenious than himself will be able to devise other clever ways to enable their clients to take advantage of the foreign private adviser exception.

basically a result of the foreign private adviser exception. By virtue of the exception, the Dodd-Frank Act does not require that every shadow bank that invests in the United States register and make systemic risk information available to the SEC, let alone every shadow bank in the world.[162] Nonetheless these entities pose a systemic risk to other participants in the United States' markets. Forcing every shadow bank that invests money in the United States to register with the SEC would raise the costs of investing in the United States, thereby tending to deter foreign investment. This is undesirable for numerous policy reasons.[163] As for requiring every investment adviser in the world to register with the SEC, this is a ridiculous proposition. The United States simply does not have lawful jurisdiction to enforce any such requirement and it would be contrary to accepted standards of international comity.[164]

Part III(a): International Regulatory Cooperation Necessary

International regulatory cooperation is necessary in connection with the Dodd-Frank Act for two reasons. First, regulatory cooperation will be necessary for the SEC to be able to verify that the information disclosed to it by advisers to foreign entities is accurate and in accordance with the Dodd-Frank Act. In the event that the SEC believes that such information might be false, the SEC will have to be able to obtain sufficient information from the foreign entity to verify the accuracy of the disclosures made by its adviser. Second, regulatory cooperation will be necessary for effective use of the information obtained under the Dodd-Frank Act for systemic risk regulation. There may arise situations in which the systemic risk information provided in accordance with the Act will indicate that a foreign entity could pose a threat to the financial stability of the United States. A foreign entity that is not required to provide systemic risk information under the act could be judged to pose a threat to the financial system of the United States if: (1) a significant number of reporting advisers indicated that they

162 *See generally* Michael I. Overmyer, *Note: The "Foreign Private Adviser" Exemption: A Potential Gap in the New Systemic Risk Regulatory Architecture*, 110 COLUM. L. REV. 2185 (proposing that the foreign private adviser exemption should be eliminated because it constitutes a chink in the SEC's ability to regulate systemic risk).

163 As the United States currently runs a rather large current account deficit, it is reliant on the willingness of foreigners to invest money in it in order to maintain the value of its currency. Therefore it seems dangerous to deter such foreign investment.

164 *See generally* Richard K. Gordon, *On the Use and Abuse of Standards for Law: Global Governance and Offshore Financial Centers*, 88 N.C. L. Rev. 501 (2010) (discussing past transgressions on national sovereignty).

had exposure to that entity; (2) a few advisers to large, systemically important entities indicated that they had significant exposure to the non-reporting entity; or (3) many reporting advisers had exposure to a market to which that entity could pose a systemic risk. In such a situation United States regulators may wish to obtain information relating to the stability of the non-reporting entity. Alternatively, the necessity of making a request may be avoided if United States regulators are satisfied that the non-reporting entity is subject to adequate foreign regulation.

Part III(b): Current International Cooperation and Information Sharing Agreements

This section will consider past efforts to obtain international information sharing agreements and to achieve international harmonization of law. This will indicate whether current information sharing agreements are adequate for United States regulators to obtain the information necessary to regulate systemic risk in accordance with the Dodd-Frank Act, or, if not, how easily such agreements could be obtained and whether significant harmonization of regulation is likely to be achieved in the realm of systemic risk regulation.

Organization for Economic Cooperation and Development

The Organization for Economic Cooperation and Development ("OECD") has shown great interest in combating what it refers to as harmful tax competition. The OECD apparently believes that a "level playing field" in taxation is necessary to ensure continued global economic growth.[165] The OECD's initial plan to counter this problem, the 1998 Report, was ambitious and involved a broad attempt to harmonize international tax codes.[166] This plan included promulgating model bilateral information sharing agreements on tax matters.[167]

---

165 Org. for Econ. Cooperation and Dev. [OECD], *Harmful Tax Competition*, *An Emerging Global Issue*, OECD Taxation Vol. 1998, No. 4, pp. 1-82 (1998), *available at* http://www.oecd.org/dataoecd/33/0/1904176.pdf [hereinafter *Harmful Tax Competition*].

166 *Id.* at 37-40.

167 OECD, *Agreement on Exchange of Information on Tax Matters* (2002), *available at* http://www.oecd-ilibrary.org/taxation/implementing-the-tax-transparency-standards/the-2002-model-agreement-on-exchange-of-information-on-tax-matters-and-its-commentary_9789264088016-7-en;jsessionid=10hqycy1e9to8.delta.

The recommendations of the OECD's 1998 Report included the adoption of certain domestic legislation to eliminate what it characterized as harmful tax practices, the adoption of tax treaties, and an agreement that countries take collective action against jurisdictions that did not implement the agreed tax standards.[168] An important shift in focus began in the 2000 Progress Report. Rather than focusing on eliminating tax competition altogether and leveling the playing field, the OECD in 2000 shifted its focus to obtaining the cooperation of non-members with member countries on tax matters.[169] The OECD developed an internationally agreed tax standard, which provides that domestic law will not prevent countries from exchanging information on tax matters.[170]

In its 2004 Progress Report the OECD catalogued its success in getting member countries to abolish their allegedly harmful tax practices.[171] The OECD was also successful in obtaining commitments from non-members to cooperate in the exchange of tax information.[172] However, progress toward the level playing field of the 1998 Report had not moved beyond a general agreement that this ideal was about fairness.[173]

The 1998 Report identified a tax haven as a country with zero or only nominal taxation, a lack of effective exchange of information, a lack of transparency, and a lack of a substantial activities requirement.[174] Yet now it seems the only requirement for a country to be substantially compliant with the internationally agreed tax standard is effective exchange of

168 *Harmful Tax Competition*, *supra* note 165, at 39-40.

169 OECD, *Report to the 2000 Ministerial Council meeting and Recommendations by the Committee on Fiscal Affairs*, at 18 (2000), *available at* http://www.oecd.org/dataoecd/25/27/44430257.pdf.

170 OECD, *A progress Report on the Jurisdictions Surveyed by the OECD Global Forum in Implementing the Internationally Agreed Tax Standard*, at n.1 (2011), *available at* http://www.oecd.org/dataoecd/50/0/43606256.pdf.

171 OECD, *The OECD's Project on Harmful Tax Practices: The 2004 Progress Report*, at 5-11(2004), *available at* http://www.irdcec.it/system/files/imce/aree-tematiche/pac/FINT_harmful%20tax%20competition%202004.pdf.

172 *See id.* at 13-14.

173 *See id.* at 12.

174 *Harmful Tax Competition*, *supra* note 165, at 39-40.

information.[175] Gone are mentions of "leveling the playing field."[176] It seems the OECD has had, for the time being, to give up its ambitious plans to harmonize tax systems and to settle for international information exchange agreements.[177] Even these information exchange agreements are very narrowly drawn.[178] Thus, despite the importance of taxation to its members, the OECD was only able to obtain limited information exchange agreements from non-members.

Bank for International Settlements

The Bank for International Settlements ("BIS") "is an international organization which fosters international monetary and financial cooperation and serves as a bank for central banks."[179] BIS has spawned a series of subcommittees, several of which are concerned with ensuring global financial stability.[180]

The most famous of these is the Basel Committee on Banking Supervision ("BCBS"), which issues the Core Principles for Effective Banking Supervision and the Concordat on Cross-Border Banking Supervision, otherwise known as the Basel Accord.[181] Basel I set minimum capital requirements for the traditional banks of member countries.[182]

175 OECD, *A progress Report on the Jurisdictions Surveyed by the OECD Global Forum in Implementing the Internationally Agreed Tax Standard*, at n.1 (2011), *available at* http://www.oecd.org/dataoecd/50/0/43606256.pdf.

176 *See Harmful Tax Competition*, *supra* note 165, at 9, 56, 70.

177 *See generally* Gordon, *supra* note 164, at 526-638.

178 *See, e.g.*, Agreement between the Governments of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland, Including the Government of the Cayman Islands, for the Exchange of Information Relating to Taxes, U.S.-U.K., Nov. 27, 2001, T.I.A.S. No. 13175.

179 Bank for International Settlements [BIS], About BIS, http://www.bis.org/about /index.htm (last visited Jan. 12, 2011).

180 *See* BIS, Monetary & Financial Stability – Overview, http://www.bis.org/stability.htm (last visited Jan. 12, 2011).

181 BIS, About the Basel Committee, http://www.bis.org/bcbs/index.htm (last visited Jan. 12, 2011).

182 Basel Committee on Banking Supervision [BCBS], *International Convergence of Capital Measurement and Capital Standards*, at 3-8 (1988), *available at* http://www.bis.org/publ/bcbsc111.pdf.

These capital requirements were calculated on the bases of a bank's capital structure[183] and the risk categories into which a bank's assets fell.[184] Basel I did succeed in raising the average capital ratios of member's banking systems.[185] However, Basel I faced enforcement problems because regulators were under pressure to interpret loosely the requirements of the accord to favor domestic banks.[186]

In 2004 Basel II was adopted in response to criticism that Basel I failed to level the regulatory playing field because its provisions were subject to diverse interpretation and failed to weigh capital and asset risks realistically.[187] Basel II allowed regulators to permit supervised banks to conduct their own internal risk management assessments.[188] Despite its formidable size,[189] Basel II failed to achieve consistent international application.[190]

BCBS recently made public the Basel III agreement. Basel III increases bank reserve requirements and creates a fluctuating conservation buffer.[191] Basel III builds on the foundations set by Basel II and is estimated to increase market risk capital requirements by three to four

183 *Id.*

184 *Id.* at 8-13.

185 *See* ETHAN B. KAPSTEIN, GOVERNING THE GLOBAL ECONOMY: INTERNATIONAL FINANCE AND THE STATE 120-22 (1994); TONY PORTER, STATES, MARKETS AND REGIMES IN GLOBAL FINANCE 76-78 (1993).

186 *See* Pierre-Hugues Verdier, *Transnational Regulatory Networks and Their Limits*, 34 YALE J. INT'L L. 113, 137-39 (2009).

187 *See id.* at 139-40.

188 *See id.* at 140.

189 *See* BCBS, *Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive Version* (2006), *available at* http://www.bis.org/publ/bcbs107.htm (The compilation of all the relevant accords, amendments and papers is 347 pages in length).

190 *See* Verdier, *supra* note 186, at 142.

191 Press Release, BCBS, Group of Governors and Heads of Supervision Announces Higher Global Minimum Capital Standards (Sept. 12, 2010), *available at* http://www.bis.org/press/p100912.htm.

times.[192] Only time will tell whether Basel III will be more uniformly applied than Basel I and II and will succeed in achieving a more stable international banking system.

The International Organization of Securities Commissions

The International Organization of Securities Commissions ("IOSCO") has succeeded in getting 71 countries to sign its Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information ("MMOU").[193] This was achieved comparatively easily because of homogeneity of interests.[194] All countries share an interest in having a reputation for sound, non-fraudulent financial markets to attract foreign investment.

The MMOU states that securities regulators of signatories will provide broad assistance to requesting regulators about financial transactions and that the transfer of information will not be hampered by secrecy laws.[195] The MMOU states: "The Authorities will, within the framework of this Memorandum of Understanding, provide each other with the fullest assistance permissible to secure compliance with the respective Laws and Regulations of the Authorities."[196] This assistance includes not only providing the requesting authorities with all relevant documents held in the files of the responding regulatory agency, but also obtaining further information.[197] This information may include:

---

192 *See* Press Release, BCBS, Adjustments to the Basel II market risk framework announced by the Basel Committee (18 June 2010), *available at* http://www.bis.org/press/p100618.htm.

193 *See* Int'l Org. of Securities Commissions [IOSCO], List of Signatories to the IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information, http://www.iosco.org/library/index.cfm?section=mou_siglist (last visited Jan. 12, 2011).

194 *See* Verdier, *supra* note 186, at 143.

195 IOSCO, *Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information* (2002), http://www.iosco.org/library/index.cfm?section=pubdocs&year=2002&publicDocID=126 (last visited Jan. 12, 2011).

196 *Id.* at 4.

197 *Id*.

> contemporaneous records sufficient to reconstruct all securities and derivatives transactions, including records of all funds and assets transferred into and out of bank and brokerage accounts relating to these transactions; records that identify: the beneficial owner and controller, and for each transaction, the account holder; the amount purchased or sold; the time of the transaction; the price of the transaction; and the individual and the bank or broker and brokerage house that handled the transaction; and information identifying persons who beneficially own or control non-natural Persons organized in the jurisdiction of the Requested Authority.[198]

Assistance under the MMOUs cannot be denied merely because "the type of conduct under investigation would not be a violation of the Laws and Regulations of the Requested Authority."[199] Requests for assistance under the MMOUs are to be made in writing and include the nature of "the laws or regulations that may have been violated and that relate to the subject matter of the request."[200] The information obtained through the use of the MMOUs can be used only for the purposes stated in the request for assistance, and must be kept confidential.[201] The MMOU does require all authorities to provide to other authorities, without request, any information which is likely to be of assistance to those other authorities.[202] Any authority can terminate its agreement to the MMOU upon 30 days notice.[203] Importantly the MMOU requests do not require that regulatory authorities take steps to prevent, or mitigate the consequences of, the activity that is the subject of a request for assistance under an MMOU.[204] Foreign judgments

---

198 *Id.* at 4-5.

199 *Id.* at 5.

200 IOSCO, *Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information*, at 5 (2002), http://www.iosco.org/library/index.cfm?section=pubdocs&year=2002&publicDocID=126 (last visited Jan. 12, 2011).

201 *Id.* at 6-8.

202 *Id.* at 8.

203 *Id.* at 9.

204 *See id.* at 9.

resulting from the information obtained cannot be enforced by virtue of the MMOU.[205] Therefore, under the MMOU the regulators of one country could not request that regulators of a second country prevent an entity in that country from entering into transactions that create or increase systemic risk.

The MMOU has done nothing to harmonize countries' securities laws.[206] The MMOU provides for specific instances of cooperation rather than broad or continuing cooperation. However, the MMOU does enable United States regulators to request information from entities in other countries if the United States regulators have reason to believe that false disclosures have been made. But, crucially, the MMOU does not facilitate international information exchange for systemic risk purposes, absent an allegation of a breach of securities law.

Financial Action Task Force

The Financial Action Task Force ("FATF") is an inter-governmental policy making body that promotes and coordinates the harmonization of national laws to combat money laundering and terrorist financing.[207] The FATF has promulgated a number of recommendations to countries regarding how they should implement effective anti-money laundering ("AML") and counter-terrorist financing ("CTF") laws.[208] FATF recommends the adoption of laws requiring financial institutions to conduct customer due diligence, commonly known as "know your customer rules," and to keep appropriate records.[209] Additionally, FATF recommends the passage of laws requiring financial institutions to report suspicious behavior,[210] and that countries set up regulatory bodies for the purpose of

---

205 *See* Verdier, *supra* note 186, at 147 (citing William S. Dodge, *Breaking the Public Law Taboo*, 43 HARV. INT'L L.J. 161, 187-89 (2002)).

206 *Id*.

207 Financial Action Task Force [FATF], *An introduction to the FATF and its work,* at 2 (2010), *available at* http://www.fatf-gafi.org/dataoecd/48/11/45139480.pdf.

208 *See* FATF, *Methodology for Assessing Compliance with the FATF 40 Recommendations and the FATF 9 Special Recommendations* (2004), *available at* http://www.fatf-gafi.org/dataoecd/16/54/40339628.pdf.

209 *Id.* at 15-23.

210 *Id.* at 25.

enforcing compliance and analyzing information collected.[211] FATF encourages countries to sign treaties and to ensure that domestic law facilitates international cooperation on AML and CTF actions.[212] This cooperation not only extends to supplying information, but also to seizing assets and evidence.[213] FATF urges that the greatest assistance possible should be provided even if the activity deemed suspicious is not a breach of domestic law.[214]

The FATF seeks to encourage compliance with its recommendations by conducting mutual evaluations of countries.[215] Lists of countries that deemed non-cooperative due to lack of AML and CFT enforcement systems have been published by FATF.[216] The FATF then recommends and coordinates preventative measures against such countries.[217] These preventative measures include enhanced scrutiny of transactions involving those jurisdictions:[218] "In addition to enhanced scrutiny, the FATF will, if necessary, ultimately call for the application of appropriate counter-measures in order to protect the financial system."[219]

As demonstrated above, FATF begins the process of obtaining compliance softly, by merely making recommendations, but if these

---

211 *Id.* at 34-37.

212 *Id.* at 42, 45.

213 FATF, *Methodology for Assessing Compliance with the FATF 40 Recommendations and the FATF 9 Special Recommendations*, at 42-45, *available at* http://www.fatf-gafi.org/dataoecd/16/54/40339628.pdf.

214 *Id.* at 43-44 ("Technical differences between the laws in the requesting and requested states, such as differences in the manner in which each country categorizes or denominates the offence should not pose an impediment to the provision of mutual legal assistance.").

215 *Id.* at 2-3. *See also* FATF, *Key Principles for Mutual Evaluations and Assessments*, *available at* http://www.fatf-gafi.org/document/34/0,3343,en_32250379_32236963_45572898_1_1_1_1,00.html.

216 *See* FATF, High-risk and Non-cooperative Jurisdictions, http://www.fatf-gafi.org/pages/0,3417,en_32250379_32236992_1_1_1_1_1,00.html (last visited Jan. 12, 2011).

217 *See id.*

218 *Id*.

219 *Id*.

"recommendations" are not followed then harder enforcement follows. Increased scrutiny of transactions with a non-cooperative country appears likely to encourage compliance by increasing the difficulty of doing business with that country, thereby reducing its trade and/or attractiveness as a destination for investment.

Financial Stability Board

The Financial Stability Board ("FSB") has a mandate from its members to monitor risks to global financial stability and make recommendations.[220] The FSB serves as an overseer of international coordination across a broad range of financial regulation.[221] It has as members not only countries,[222] but also international organizations such as the BIS, OECD, IOSCO, IMF, and the World Bank.[223] The G20 established the FSB as the successor to the Financial Stability Forum ("FSF") in 2009.[224]

The FSF was founded in 1999 to promote cooperation between the already existing national and international supervisory bodies.[225] The FSF has compiled a list of 12 standards that it has deemed to be "key for sound financial systems and deserving of priority implementation depending on country circumstances."[226] The standards were not produced by the FSF, but rather represent the collective wisdom of other international

220 Financial Stability Board [FSB], Mandate, http://www.financialstabilityboard.org /about/mandate.htm (last visited Jan. 12, 2011).

221 FSB, Overview, http://www.financialstabilityboard.org/about/overview.htm (last visited Jan. 12, 2011).

222 *See* FSB, Links to FSB Members, http://www.financialstabilityboard.org/ members/links.htm (last visited Jan. 12, 2011). Current member countries of the FSB include all G20 members plus Hong Kong, The Netherlands, Singapore, Spain and Switzerland. *Id.*

223 *Id.*

224 FSB, History, http://www.financialstabilityboard.org/about/history.htm (last visited Jan. 12, 2011).

225 *Id.*

226 FSB, 12 Keys Standards for Sound Financial Systems, http://www.financialstabilityboard.org/cos/key_standards.htm (last visited Jan. 12, 2011).

organizations such as the OECD, FATF, BCBS, and IOSCO.[227] These standards include FATF's Forty Recommendations,[228] BCBS's Core Principles for Effective Banking Supervision,[229] and IOSCO's Objectives and Principles of Securities Regulation.[230]

The FSB does not possess any power to enforce its recommendations.[231] Rather it coordinates the adoption of standards to promote financial stability and reports on the progress of that adoption.[232] Also, the FSB conducts reviews of individual member countries' progress in implementing its standards.[233] Overall the FSB aims to convince countries that adopting certain standards of financial regulation is not only individually beneficial for countries, but is mutually beneficial to all the members of the international financial community.

Overview of International Cooperation

International information sharing is limited to an exchange of the information requested. Countries do not share all of their tax or regulatory information in the absence of a specific request since this information is both voluminous and subject to misuse. In neither area has significant global harmonization been achieved.

227*Id*.

228 FATF, *FATF 40 Recommendations* (2003), *available at* http://www.fatf-gafi.org/document/28/0,3343,en_32250379_32236920_33658140_1_1_1_1,00.html.

229 BCBS, *Core Principles for Effective Banking Supervision* (2006), *available at* http://www.bis.org/publ/bcbs129.pdf.

230 IOSCO, *Objectives and Principles of Securities Regulation*, (2003), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf.

231 FSB, Mandate, http://www.financialstabilityboard.org/about/mandate.htm (last visited Jan. 12, 2011).

232 *See, e.g.*, FSB, *Overview of Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability*, (2010), *available at* http://www.financialstabilityboard.org/publications/r_100627c.pdf; FSB, *Ongoing and Recent Work Relevant to Sound Financial Systems,* (2010), *available at* http://www.financialstabilityboard.org/publications/on_1006.pdf.

233 *See, e.g.*, FSB, *Country Review of Mexico*, (2010), *available at* http://www.financialstabilityboard.org/publications/r_100927.pdf.

Although there were attempts by the OECD to harmonize global tax laws,[234] the OECD has backed away from this goal and settled for narrow information exchange agreements.[235] The fact that such a desirable outcome for many powerful countries could not be achieved by an organization as influential as the OECD is an indication of just how difficult it is to achieve harmonization of national laws.

Certain organizations, however, have been quite successful in obtaining international harmonization. The Basel Committee, despite some bending of its rules by regulators, has been successful in obtaining a general increase in the reserve requirements of banking systems around the world. Also, the FATF has obtained nearly universal cooperation in the anti-money-laundering and counter terrorist financing areas, along with a great degree of harmonization of national laws in these areas. The explanation of these successes probably lies with a greater alignment of interests and backing by a more powerful global political will.

As far as securities regulation is concerned, IOSCO has obtained broad cooperation in the realm of information sharing. However, information sharing is the only form of cooperation agreed to. There must have been a suspected breach of law or regulation for information to be shared, and no harmonization of securities regulation has been achieved. These attempts at international cooperation in the regulation of banking, taxation, and AML/CTF show that harmonization of national law is unlikely, absent an alignment of national interests and/or strong global political will, but that limited agreements to cooperate can be achieved with comparative ease.[236]

The MMOU allows countries to gain specific information relating to violations of securities regulations. Thus, United States regulators could obtain information if they believed that systemic risk information provided in accordance with the Dodd-Frank Act was false. However, and most importantly, present agreements do not allow for information exchange absent an allegation of a breach of securities regulations. This condition

---

234 *See Harmful Tax Competition*, *supra* note 165, at 39-40; OECD, *Report to the 2000 Ministerial Council meeting and Recommendations by the Committee on Fiscal Affairs*, at 12-14 (2000), *available at* http://www.oecd.org/dataoecd/25/27/44430257.pdf.

235 OECD, The Global Forum on Transparency and Exchange of Information for Tax Purposes, *Statement of Outcomes* (2010), *available at* http://www.oecd.org/dataoecd/1/49/46107244.pdf.

236 *See* Verdier, *supra* note 187, at 148.

hampers the ability of United States regulators to judge the risks posed to the United States' financial system by entities not required to report under the act. Also, cooperation in securities enforcement is limited to information exchange; therefore, the SEC could not necessarily get its decisions enforced by foreign regulators.

Past attempts to harmonize national laws, like the OECD's tax initiatives, have met with limited success. Such attempts have only succeeded where there was an incentive for countries to implement those laws. Therefore, it will be important for regulators to emphasize the mutual benefits that will be achieved by reductions in systemic risk caused by the adoption of harmonious standards of regulation. Systemic stability is a public good that spans the global financial system, and every country stands to gain if systemic risk in the international financial system is reduced. Also, harmonization of systemic risk regulation would probably mean that international financial companies will not be subjected to duplicative or redundant regulation.

Information sharing for purposes of systemic risk regulation is of greater value to OFCs than agreements for the sharing of tax information. Whereas it is primarily large onshore jurisdictions that benefit from the information sharing provisions of tax treaties, information sharing for systemic risk regulation has the potential to yield mutual benefits. Therefore, in light of the OECD's success in obtaining information sharing agreements for taxation, it is reasonable to believe that it will be possible to obtain information sharing agreements for systemic risk regulation.

This system of regulation will look much more like banking supervision overseen by BCBS than traditional securities regulation. Traditional securities regulation was aimed primarily at protecting investors from specific fraud, market manipulation, and insider trading. The focus of new regulations, such as those provided for in the Dodd-Frank Act, is to protect investors from the general contagion of individual financial failures. This function more closely resembles the protection of individual depositors by maintaining the soundness of the banking system than it does traditional securities regulation. Given the divergent standards adopted in the United States and in the European Union, harmonization like that achieved by BCBS appears unlikely in the area of systemic risk regulation.

Part IV: Alternative Investment Fund Managers Directive

Although there has so far been comparatively little regulation of shadow banking entities, the United States was not the only jurisdiction which the recent financial crisis spurred to legislate in this area. The European Union ("EU") has passed the Alternative Investment Fund Managers ("AIFM") Directive ("AIFM Directive").[237] It will regulate European shadow banks exempt from the UCITS Directive, which regulates mutual funds.[238] It is interesting to compare the AIFM Directive with the Dodd-Frank Act because both pieces of legislation represent a move into relatively uncharted regulatory territory.[239]

Importantly, unlike the Dodd-Frank Act, the AIFM Directive has the effect of preventing AIFM based in a country outside the EU from marketing their funds in the EU unless that country has appropriate information exchange agreements with an EU Member State.[240] Similar rules apply even if AIFM are based in the EU and only the funds they manage are outside the EU.[241] These prohibitions differ from the foreign private adviser exception of the Dodd-Frank Act because they bar outright foreign advisers from marketing their funds in the EU unless those funds are based in countries that allow information exchange. Dodd-Frank allows advisers to market their funds in the United States provided that they register and provide systemic risk information as requested. However, Dodd-Frank does not provide a mechanism to ensure that this information can be verified.

---

237 Council Directive 2011/61, of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010, 2011 O.J. (L 174) 1 (EU), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDF [hereinafter AIFM Directive].

238 *Id.* at 1.

239 The author would like to caveat his discussion of the AIFM Directive by stating that because of space constraints the discussion of the directive's provisions here will be brief and simplistic.

240 *See* AIFM Directive, *supra* note 237, art. 40(2)(a). This is actually a great simplification. The AIFM Directive contains several different articles setting forth the rules for AIFM depending on their location and the location of the funds they manage. Article 40 sets forth the rules for an AIFM based outside the EU to market a fund also based outside the EU within the EU by use of the "passport" provision. A "passport" basically enables an AIFM to market its funds in the EU provided it is authorized by a member state in accordance with the AIFM directive. *See* AIFM Directive, *supra* note 237, art. 32.

241 AIFM Directive, *supra* note 237, arts. 35 and 36.

Apart from its scope, the AIFM Directive differs in that it asserts control over the actions of advisers to shadow banks. The AIFM Directive provides that AIFM must make annual reports for the funds they manage available upon request.[242] Also AIFM are required to make certain other disclosures to investors including a description of the investment strategy of the fund, the techniques they may employ, the liquidity of their investments and the leverage they use.[243] The AIFM Directive also governs the remuneration of AIFM and allows a member state to regulate conflicts of interest between AIFM and the funds they manage.[244] The directive requires AIFM to review and maintain risk management systems and conduct stress tests to assess the liquidity risk of the funds they manage.[245]

The exact extent of the information required under the Dodd-Frank Act can vary because the FSOC and the SEC are allowed to require such further information as they deem necessary,[246] but there is a general difference in the information collected by the Dodd-Frank Act and the AIFM Directive. Whereas the Dodd-Frank Act aims to collect raw data from the adviser for the benefit of regulators, the AIFM Directive appears to be concerned both with regulating AIFM's methodology and requiring public disclosures so that investors in funds managed by AIFM can make informed investing decisions.[247] The AIFM Directive tries to regulate AIFM behavior to lower risks of systemic problems *ex ante* whereas the Dodd-Frank Act seeks to provide regulators with the information necessary to take action to avert a developing systemic crisis.

So from the start, global regulation of shadow banking entities will not be harmonious. Therefore, shadow banks will potentially have to deal with distinct, but largely repetitive, regimes of systemic risk regulation. The AIFM Directive anticipates such problems by exempting AIFM from

---

242 *Id.* art. 22.

243 *Id.* art. 23.

244 *Id.* arts. 13 and 14.

245 *Id.* arts. 15 and 16.

246 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 404, 124 Stat. 1376, 1571-72 (2010).

247 *Compare* § 404(2), 124 Stat. at 1571-72, *with* AIFM Directive, *supra* note 237, arts 12-24.

compliance with its provisions provided they are already in compliance with incompatible rules or regulations that provide investors with an equivalent level of protection.[248] Indeed, it will be interesting to see whether EU regulators will hold that the Dodd-Frank Act "provides for an equivalent rule (as the AIFM Directive) having the same regulatory purpose and offering the same level of protection to… investors…"[249]

Despite the differences between the Dodd-Frank Act and the AIFM Directive, both sets of regulation do take into account the fact that entities might already be subject to foreign regulation.[250] Proposals have been made in the United States that securities regulators should take greater account of compliance with foreign securities regulations when determining whether full SEC regulatory oversight is necessary.[251] Therefore, even if regulatory regimes differ in important ways, it is possible that the necessity of international information sharing and the burden of complying with redundant layers of regulation will be reduced if governments accept that entities are already adequately regulated by foreign countries.

Part V: New agreements needed to allow exchange of systemic risk information.

The efforts of the OECD and IOSCO show that it is very difficult to convince countries to harmonize their laws. Even if such harmonization of national laws could be achieved, BCBS's experience with national regulators bending its rules to favor domestic entities indicates that such regulation is unlikely to be uniformly applied. Therefore, it is unlikely that

248 AIFM Directive, *supra* note 237, art. 37.

249 *Id.* art. 37(2)(b).

250 *See, e.g.*, *id.* art. 37; Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 113(b)(2)(H), 115(b)(2), 124 Stat. 1376, 1399, 1403 (2010).

251 *See* Ethiopis Tafara & Robert J. Peterson, *A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*, 48 HARV. INT'L L.J. 31 (2007).

> "Instead of being subject to direct SEC supervision and U.S. federal securities regulations and rules, foreign stock exchanges and broker-dealers would apply for an exemption from SEC registration based on their compliance with substantively comparable foreign securities regulations and laws and supervision by a foreign securities regulator with oversight powers and a regulatory and enforcement philosophy substantively similar to the SEC's." *Id.* at 32.

See also International Disclosure Standards, 64 F.R. 6261 (proposed Feb. 9, 1999) (codified at 17 C.F.R. 210, 228, 229, 230, 239, 240, 249, 260).

true harmonization of systemic risk regulation will be achieved.[252] Differences between the AIFM Directive of the EU and the Dodd-Frank Act in the United States show that even onshore jurisdictions differ in how they believe shadow banks should be regulated. But harmonization may not be necessary provided countries share systemic information. Indeed the Dodd-Frank Act and the AIFM Directive anticipate such international cooperation.[253]

IOSCO's MMOU should be modified specifically to allow for cooperation in systemic risk regulation. Although the SEC has more rigorous cooperation agreements with certain foreign jurisdictions,[254] it is desirable that there be broadly-based international agreements, as systemic risk can originate in and threaten multiple jurisdictions at once. Given the past successes of international organizations in obtaining information sharing agreements, systemic risk information exchange agreements can probably be readily obtained. This is because all jurisdictions, both on and off shore, have strong interests in preventing the international contagion of financial failures.

The OECD's model tax treaties and IOSCO's MMOU show that in order for them to be widely accepted, international cooperation agreements must have strict prerequisites for information exchange and controls on how the information obtained may be used.[255] Systemic risk information exchange agreements will probably require that the requesting regulator

252 *But see* IOSCO, *Hedge Funds Oversight* (2009), *available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD293.pdf*. This document sets forth guidelines for internationally consistent regulation of the hedge fund industry.

253 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 175, 929K, 981, 124 Stat. 1376, 1442, 1860-61, 1926-27 (2010); AIFM Directive, ¶¶ 63, 69 and 84.

254 *See, e.g.*, Memorandum of Understanding between the Securities and Exchange Commission of the United States and the Financial Services Authority of the United Kingdom, (Sept. 25, 1991), *available at www.sec.gov/about/offices/oia/oia_multilateral/ukfsa_mou.pdf.*

255 *See, e.g.*, Agreement between the Governments of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland, Including the Government of the Cayman Islands, for the Exchange of Information Relating to Taxes, U.S.-U.K., Nov. 27, 2001, T.I.A.S. No. 13175; IOSCO, *Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information* (2002), *available at* http://www.iosco.org/library/index.cfm?section=pubdocs&year=2002&publicDocID=126.

specify the reasons why a given shadow bank is thought to pose a threat to the financial system of the requesting country, and the request will have to state the nature of the information desired. Further, the agreement should contain provisions restricting the purposes for which the information obtained may be used so as to prevent fishing expeditions for tax information under the auspices of systemic risk regulation.[256] The agreements will have to provide that information will not be released publicly, both to prevent proprietary strategies of shadow banks from being revealed, and to ensure that the mere fact of the request does not have adverse effects on any particular shadow bank.[257]

If some jurisdictions do not accede to sign information-sharing agreements, then other jurisdictions can follow the familiar steps to obtain these agreements. First, organizations like the FSB could perhaps persuade noncompliant jurisdictions that adopting information sharing agreements is really in their own self interest. Second, jurisdictions that do not share information could be named and shamed in the same way as the OECD and FATF named and shamed jurisdictions that did not adopt their recommendations. If this is not sufficient, then domestic entities transacting with noncompliant jurisdictions could be subjected to a heightened level of systemic risk scrutiny. This would raise the cost of doing business with these jurisdictions and provide them with a strong incentive to enter into information sharing agreements.

As shadow banks in OFCs cater to nonresidents, these shadow banks will experience high costs if they have to comply with multiple foreign regulatory standards in order to be able to market their services in onshore jurisdictions. These costs will encourage OFCs to adopt levels of regulation that onshore regulators will accept as sufficient to make additional onshore regulation unnecessary. This does not necessarily require that the OFC adopt identical systemic risk regulation. OFCs probably will attempt to adopt lighter, perhaps more efficient regulations that would nonetheless be found to be substantially similar in their effects to those of onshore jurisdictions.

---

256 *See, e.g.*, AIFM Directive, *supra* note 237, art. 52 (permitting the transfer of information to third countries to the extent necessary to further the purposes of the AIFM Directive).

257 For instance, investors, upon learning that there had been a request for information, might attempt to withdraw their investment from the shadow bank fearing that regulators know something the investors did not. The Dodd-Frank Act anticipates such problems and in section 112 exempts the Financial Stability Oversight Committee from certain Freedom of Information Act requirements.

Conclusion

The aim of global systemic risk regulation should be to fill risk-information gaps. Individual shadow banks have an incentive to maintain the secrecy of their operations to preserve the value of their proprietary trading strategies. This impedes the ability of participants in the market for asset management to deter excessive risk taking with investors' funds. Regulators should ensure that investors obtain the maximum amount of information that is compatible with preservation of proprietary strategies, thus allowing risk-averse individual investors to minimize systemic risk as far as possible. Regulators should then focus on collecting confidential information nationally and internationally that will enable them to monitor systemic risk through network analysis and examination of systemically important shadow banks' balance sheets.

Although international harmonization of systemic risk regulation is desirable to minimize compliance costs for shadow banks and ease the burdens of information sharing on national regulators, both past experience of attempts at such harmonization and the significant differences between the American and European approaches to systemic risk regulation indicate that such harmonization is unlikely. A mixture of international information sharing agreements to allow the exchange of systemic risk regulation, combined with acceptance in appropriate instances that foreign entities are already subject to adequate regulation, is the most efficient and feasible course. The fact that many countries have already signed agreements to share information relating to securities regulation indicates that agreements for systemic risk information sharing should be obtainable.