INVESTMENT
INDUSTRY ASSOCIATION
OF CANADA

Letter from the President

Takeaways from the SIFMA Annual Conference November 8, 2010

The sweeping reforms to financial regulations in the United States are bound to have significant impact on other jurisdictions, notably Canada. That's why I was glad to get the chance to attend the annual conference of SIFMA, the trade association for the U.S. securities industry. Given the spate of legislative and regulatory activity, it is not surprising that the November 8th event drew record attendance. It provided a high-profile platform for key U.S. securities regulators from the SEC, FDIC and Federal Reserve Board of Governors, as well as industry professionals, with leaders including James Gorman (CEO of Morgan Stanley), Bob Kelly (CEO of Bank of New York Mellon), Tim Ryan (CEO of SIFMA) and John Taft (Chair of SIFMA). The format for every conference session, with the exception of the speech by Federal Reserve Board Governor Kevin Warsh, was a series of informal conversations with talk show host Charlie Rose. The format fostered wide-ranging commentary on various aspects of reform from different perspectives, with the conversations yielding several important insights.

The purpose of this President's Letter is to describe these insights and provide my interpretation and perspective, particularly the relevance of these initiatives for the Canadian market.

1. **Regulatory Reform: How Much Can the Regulatory System Handle?** SIFMA's top priority is to contribute actively to the ongoing and comprehensive reform agenda in the United States. The securities industry is working closely with the Administration, Congressional staff, and regulators to put in place reforms that contribute to market efficiency and bolster investor trust and confidence. The priority is to design a regulatory oversight framework to mitigate systemic risk, establish rules and structural reforms for exchange trading and central clearing of derivatives, improve securitized markets, develop appropriate liquidity and capital rules, clarify the definition of the Volcker Rule (prohibiting proprietary trading in banks) and build an effective fiduciary standard for advisors and broker-dealers.

Several industry executives expressed concerns that the breadth and depth of regulatory reform in U.S. markets – embracing rule-making and structural reform, with the Dodd-Frank legislation as the centerpiece – could overwhelm regulatory capacity. For example, outgoing Senate Banking Committee Chairman, Christopher Dodd, pointed out there were 250 work streams involved in legislation he co-sponsored. The SEC had indicated its rule-making exercise will embrace at least 200 new rules. This could lead to delays in implementing reforms and raise the risks of unintended consequences. It was emphasized several times that regulators needed to get reforms right and the industry had an obligation to contribute proactively to the reform process. At the same time, it was echoed in commentary that regulatory reform must proceed quickly to address market and institutional shortcomings caused by the financial crisis, to shore up investor confidence and to reinvigorate the savings-investment process. For example, it was noted that the Commodities Futures Trading Commission (CFTC) rule-making exercise should be completed by year end. This rapid rule-making timetable may cause the reform process to move quickly in other jurisdictions.

2. **Industry Priorities:** The conference highlighted several priority regulatory initiatives for the U.S. securities industry. SIFMA and its committees are actively engaged with Congressional staff and regulators in designing an effective framework to coordinate market oversight among the different regulatory bodies and mitigate systemic market risk. On several occasions during the conference, it was remarked that the U.S. capital markets had too many regulators, a legacy of 20th Century markets and institutional arrangements, and a 60-year experience with Glass-Steagall legislation.

   The reform agenda also addresses the "too big to fail" issue, through tougher capital and liquidity rules, constraints on off-balance sheet activity, and mandated requirements for orderly institutional windup.

3. **Volcker Rule:** The securities industry is placing much effort on clarifying the Volcker Rule that prohibits proprietary trading within banks. The industry wants to ensure these rules don't interfere with market-making in securities on behalf of clients and diminish market liquidity. This will not be an easy task as market-making activity for clients involves proprietary dealings, as firms take offsetting principal positions to facilitate client trades.

4. **The Flash Crash:** Mary Schapiro, SEC Chairman, focused on the May 6 "flash crash", a topic of much discussion at the conference. In her view, it demonstrated the frailties of U.S. secondary equity markets. She pointed to recent reforms, including circuit breakers to halt trading in response to sharp price movements, the ability to break trades, and proposed rules to deal with High Frequency Traders (HFTs). The SEC had just issued a concept paper containing proposals that require registration of HFTs, impose pre-trade risk management of HFT market activity, provide market surveillance, require large trade reporting and impose risk controls on algo trading by slowing trading activity concurrent with surges in market trading volume.

   The industry panel on market structure (made up of representatives from the major marketplaces including the CME, NYSE and NASDAQ) supported the SEC proposals for pre-trade risk management of HFTs and requirements for monitoring HFT trading activity. But they questioned the feasibility of certifying mathematical formulae related to algorithmic trading. The panel members generally concluded that HFTs, which embrace a wide range of market strategies, contribute on balance to deeper and more liquid domestic markets. They concluded, as well, that the proposed reforms are sufficient to address market efficiency, systemic risk and investor confidence. They generally acknowledged there are some "bad actors" within the HFT community, and regulators and broker-dealers need to be vigilant to identify and remove these players from the market.

   The panel participants expressed the need for greater market transparency and less market internalization to promote a better price discovery process. Several participants commented that the existing multiple market environment in the United States is not an ideal arrangement, but it functions efficiently and fairly. Lack of investor confidence is rooted more in weak market conditions and market volatility than in market structure. The SIFMA discussions suggest that, while significant market reform is still needed in the Canadian context, Canadian equity markets are in better shape from the standpoint of fragmentation and transparency.

5. **Monetary Policy, Stimulus or Supply Side?** Federal Reserve Board Governor Kevin Warsh rejected the common interpretation that the middling, economic recovery was the "new normal". In the wake of the Fed's QE2 announcement, he argued that monetary policy cannot carry the full burden

for economic recovery, but advocated emphasis on supply-side growth policies rather than short-term fiscal fixes through spending stimulus, beyond that needed to support the economy during the financial crisis. He expressed the view that recent financial developments such as ongoing deleveraging, improvements in balance sheet liquidity and the re-pricing of the U.S. housing market are contributing to a solid foundation for sustained, longer-term growth.

Warsh cautioned that recent Federal Reserve announcements, committing to purchase $75 billion of U.S. treasuries each month through the second quarter of next year, raise significant inflationary and currency risks for the economy, and could add a risk premium to U.S. Treasury bond yields. He also warned the Fed risks losing hard-earned credibility if the policy fails to deliver on its objectives.

6. **Bolstering Investor Confidence:** The conference panel sessions emphasized the importance of reforms to strengthen investor trust and confidence. Commentators made reference to rules to make the investment process more understandable and more transparent for consumers. The securities industry has recognized the need to modernize the rules for advisors and broker-dealers and to consider a broad-based fiduciary standard. However, the rule-making in this regard must take into account the different business models in the retail marketplace. Little mention was made of the newly formed Consumer Financial Protection Agency.

   The Dodd-Frank legislation has instructed the SEC to examine the merits of a fiduciary standard for broker-dealers. While the industry is supportive of the legislation, it has expressed concern that the impact of the fiduciary standard could raise costs and limit choice for small investors by increasing the regulatory burden on dealers and restricting certain activities. The industry has engaged actively with Congressional and SEC staff to ensure that, if the fiduciary standard goes forward, eventual rules will contribute to building investor confidence without unintended adverse consequences.

Yours sincerely,

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