iiac

Letter from the President

Regulatory Reform: The View From Across the Pond

Countries all over the world – in developed and emerging markets – are pursuing a broadly-based agenda of regulatory reforms. The Annual General Meeting of the International Council of Securities Associations (May 23-24) gave Canadians an opportunity to get a close-up look at how it is being pursued in Europe. Enough of the issues are similar to the challenges we face in Canada to make it a very useful exercise.

Driving Reform: The EU securities supervisory framework

At the London conference Jonathan Taylor, Managing Director for Financial Services and Stability, International and Finance, of the United Kingdom Treasury, described the three institutional drivers behind securities reform in Europe:

- The G20 initiatives launched and overseen by the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision.
- The EU supervisory framework for banking, insurance and securities.
- The national regulatory bodies that complement the EU framework. In the United Kingdom, this includes the Financial Services Authority, the Bank of England and the Treasury.

Taylor's description of the key regulatory issues corresponded to those identified by four industry practitioners from the global investment banking community in London: Credit Suisse, Citi, Société Générale and Nomura. Some of the issues flowed from the directives of the EU Securities Authority (EU MiFID, or Markets in Financial Instruments Directive). The Authority has recently been re-configured from a coordinating body to a formal regulatory authority.

EU oversight reforms – and industry concerns

These EU regulatory initiatives include rules for pre-trade and post-trade bond transparency. The industry expressed concern that these rules, requiring mandatory reporting of transaction size for each bond transaction, will interfere with efficient market-making and the liquidity of debt markets.

In response to these concerns, several U.S. regulators in attendance argued that an assessment of the transparency rules under the TRACE system, which displays traded bond volume, suggests liquidity in the U.S. traded corporate bond markets have not been adversely affected.

European regulators are gathering evidence on the impact of high-frequency trading on equity markets to ascertain the need for oversight and rules to restrict their activities. Similarly, the merits of dark pools and appropriate rules are now under review. Regulators have also proposed short-selling rules for debt and equity securities. The industry has argued the rule-making process should proceed carefully to avoid damage to market-making activities and overall liquidity.

European regulatory authorities are also engaged in the implementation of the G20 Directives. Among the important initiatives are effort to standardize OTC derivatives, introduce trade repositories for the reporting and monitoring of derivative market activity, and transitioning bilateral trading to central counterparties to mitigate market risks. Similar regulatory initiatives are underway in OTC derivatives markets in Canada, the U.S., and Asia. The industry in Europe has focused on the need to define the scope of regulation, trade repositories and recognized legal entity identifiers to track global transactions, allowable exemptions from OTC derivatives rules, and the formation and inter-operability of clearinghouses.

The European authorities have also proposed a publicly-owned credit rating agency to counter-balance private credit rating agencies such as S&P, Moody's, Fitch, etc. The industry has raised objections to this unorthodox proposal.

EU macro-prudential reforms: Stabilizing markets, not just institutions

Finally, the EU regulatory authorities are working with the Basel Committee and the Financial Stability Board to structure a new capital and liquidity rule framework under the Basel III Accords. The focus is on the definition and rules for liquidity requirements, now complicated by risk variance across the European Sovereign Debt Markets. Paul Tucker, Deputy Governor of the Bank of England, provided some insights into the macro-prudential regulatory framework, arguing that financial stability involves more than the resilience of individual financial institutions, but also embraces the stability of underlying capital markets.

Tucker segmented capital markets into three components: the inter-bank market, the intra-financial system markets that provide wholesale funding for financial institutions (repo, swaps, securities lending), and the end-user markets (cash equities and debt markets, and ABS and CDO markets). He stressed the importance of measures to facilitate liquidity and efficiency in the intra-financial system markets to mitigate risk contagion of financial institutions. He also discussed specific measures such as greater transparency, repositories and clearinghouses for derivative securities in the end-user markets.

One of the panels focused on stress-testing of individual financial institutions to assess systemic risks. There was general agreement that stress-testing has had limited success identifying vulnerable financial institutions. This reflects limitations in methodology, such as the appropriate ratios or metrics, and appropriate corporate comparative analysis. There was also broad agreement that financial stress-testing should be complemented by qualitative assessment by seasoned executives on the impact of financial and economic shocks on financial institutions.

Investor confidence: In a trough or on the mend?

A panel on investor confidence reflected differing views. Some felt that confidence in advisors, the securities industry and financial markets, and securities regulators has not yet been rebuilt, and investors remain reticent to return into the marketplace. Some panelists also referred to the confidence-debilitating impact of high-frequency trading, reflecting investor perceptions that this electronic trading activity had an unfair advantage in the equity markets. On the other hand, some panelists were convinced that confidence has been significantly restored, pointing to record levels of trading and participation in global equity markets since the crisis, suggesting investors are resilient and opportunistic, entering markets aggressively when circumstances warrant. The panel discussion also focused on regulatory initiatives under way in various jurisdictions to investor trust and confidence.

Surprisingly, none of the panelists referred to the recent scandals related to insider trading by global hedge funds (managing some $2 trillion). These hedge funds have taken the "mosaic theory" to sophisticated levels, and in some cases to questionable levels, in the search for leading-edge investment insights. The Galleon Hedge Fund charges of insider trading have dominated the media in recent weeks, following persistent allegations and investigations of trading abuses by other hedge funds over several years. These alleged abuses have undoubtedly influenced investor perceptions of market unfairness and may have had a negative impact on investor confidence that could become more endemic if further investigations are undertaken.

Regulatory objectives: Finding the 'sweet spot'

The reform process is acknowledged as a challenging task given the complexity of the regulatory reforms, tight timetables for implementation (2012 in Europe), the importance of extensive consultation with market participants, and the need for regulatory harmonization. Mark Hoban, U.K. Financial Secretary, referred to specific regulatory reforms underway in Europe, but focused most of his remarks on the objectives of the reform process. He identified the key priorities as: i) minimize disproportionate costs on market participants and avoid unintended consequences, ii) prevent barriers of entry that will stifle competition, and iii) avoid balkanizing financial markets, which would interfere with capital flows, increase market inefficiencies and cause unproductive regulatory arbitrage.

Hoban argued that the authorities are required to find a difficult balance: they must maintain momentum on reform through careful implementation of rules to stay on the defined timetable -- while keeping in step with other regulators to promote harmonization in the rule-making process.

Bringing the concerns of the Canadian industry to the table

Industry participants were also anxious to hear about the issues we face in Canada. I had the opportunity to provide delegates with a view on structural developments and regulatory initiatives in Canadian secondary equity markets. The structural changes include the increasing penetration of ATS trading, growing participation of high-frequency trading and pending consolidation of marketplaces and clearing platforms in Canada. I identified industry priorities for regulatory reform in these markets, including greater clarification of best-price/execution obligations, rigorous oversight of the pricing of stock exchange and marketplace products and services including trading market data and clearing, and the status of the single securities regulator for Canada.

Throughout the world, regulators (and the industry) are striving to deal with the need to ensure appropriate oversight, stable markets and institutions, and investor confidence. From both sides of the Atlantic we can learn from each other, and the ICSA was another opportunity to do so.

Yours sincerely,

Ian C.W. Russell, FCSI
President & CEO, IIAC
June 2011