



## *Letter from the President*

### **SEC Speaks: IIAC Listens Closely**

#### Key Observations and Lessons for Canadian Dealers

The U.S. Securities and Exchange Commission (SEC) is a busy place these days – and an important place for Canadian markets and investment dealers. As a result of the Dodd-Frank law, and other responses to the 2008 market meltdown, the SEC is pursuing an active agenda of rule-making. Much of it will have an international dimension, reflecting the regulation of the Over-The-Counter (OTC) derivatives market, the possible re-formulation of the Volcker Rule to address its complexities and the narrow scope of activities it permits, and an expected SEC concept release on extraterritorial regulation.

In light of these SEC rule-making activities, and their likely impact on the Canadian industry, IIAC took advantage of an intensive two-day seminar in Washington on the weekend of February 24-25. The seminar – SEC Speaks – provided an opportunity to hear presentations from the SEC Commissioners and senior staff on the SEC's priorities, the status of regulatory initiatives, and their implications for Canadian markets and investment dealers.

The presentations also described the restructuring underway at the SEC, including measures to reorient staff to key mission objectives, broaden staff expertise beyond traditional legal and accounting disciplines, and integrate technology and financial analysis into rule-making, enforcement and the assessment of new market products. Aside from providing a valuable window into the current thinking at the SEC, the conference – in outlining the regulator's agenda and initiatives – underscored the importance of a national regulator to pursue Canadian interests, at home and globally.

#### **Volcker Rule: Strong Support for Revision**

Several presentations addressed the Volcker Rule, the subject of an IIAC submission to the SEC in January, in which we pointed out the damage to the liquidity of Canadian government and corporate bond markets in complying with the Rule, the unfairness of limiting the exemption to U.S. government bonds, and the unprecedented extraterritorial application of the Rule.

The attention devoted to the Rule at the weekend conference is not surprising given the publicity surrounding the proposal to restrict proprietary trading by commercial banks – and the

unprecedented negative comment: some 16,000 comment letters, in terms of the specific rules and the unprecedented extraterritorial aspects of the Rule affecting the global operations of the U.S. affiliate firms.

The SEC will be heavily involved in the inter-agency response to the comments. SEC staff described the review process as delineating or "line-drawing" activities exempt from prohibited proprietary trading, including market-making for clients, hedging activity and trading in government securities.

The SEC staff recognizes the extraterritorial dimension of rule-making, in the Volcker Rule as well as the proposed rules for registering foreign clearinghouses. Several staff presentations emphasized the importance of balancing sufficient regulatory oversight with the realities of a global marketplace. It was indicated in several of the presentations that the SEC would in the near future issue a concept release on extraterritorial regulation. The inference from presentations on the Volcker Rule and the OTC derivatives agenda is that the SEC will take a conciliatory approach to circumscribing jurisdiction, focusing on recognizing "comparable regulatory standards" for foreign institutions and professionals accessing U.S. markets.

We found many of our concerns echoed by SEC Commissioner Hon. Troy A. Paredes, who strongly criticized the proposed version of the Volcker Rule. He stated the rule-making process needed more thought to address concerns about the damage to market liquidity and capital formation. In his view, the proposed Rule was too complex and gave too narrow a scope to permitted activities. He recommended the SEC examine the options to achieve the intended objectives and then re-propose the Volcker Rule for another round of public comment. The view of one Commissioner does not ensure withdrawal of the proposed Rule, but the unprecedented negative comment letters suggest a re-proposal is a likely possibility.

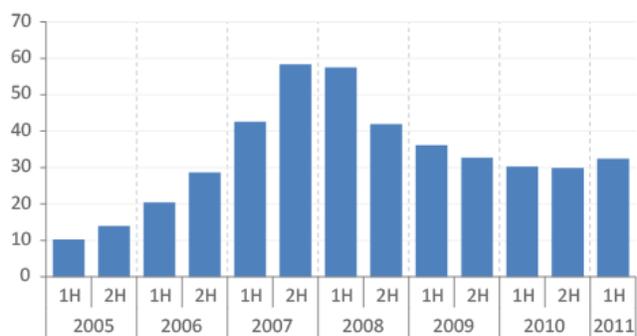
#### **OTC Derivatives Market: Comparability for Foreign Clearinghouses?**

The SEC goal in the OTC derivatives market, in response to the G20 Directives, is to develop effective margin and capital rules for derivative securities, and measures to mitigate risks in

clearing and settlement. The SEC will move forward with central clearing for OTC securities and define specific registration categories for swap dealers and clearinghouses, at the moment including ICE, CME Group (CME) and LCH.Clearnet Group. The presentations indicated that foreign clearinghouses would have difficulty meeting the U.S. standards for registration, and in this regard the SEC is considering a standard of regulatory comparability for registration of these entities.

The registration category for swap dealers will prescribe capital, margin and leverage charges. It was also made clear the SEC is working closely with the Commodity Futures Trading Commission to ensure equivalency in all registration and rule standards for the OTC derivative markets. The SEC has undertaken analysis of the Credit Default Swap (CDS) market. It was noted that the G14 Dealers held US\$24 trillion or 90% of total CDSs outstanding at the end of June 2010.

**Credit Default Swaps**  
**Notional Amount Outstanding (US\$ trillion)**



Source: Bank for International Settlements

In the conference's one reference to the MF Global collapse, SEC staff noted that the failure of MF Global did not have systemic consequences for the market, but the experience did point to the need to strengthen rules governing the segregation of client assets. These measures would include better and timelier reporting of client funds to ensure the protection of client assets.

**Retail Markets**

The SEC will move forward with a standard harmonized Code of Conduct for broker-dealers and investment advisors. This was described as a move to a uniform fiduciary duty. While the uniform standard is underway, staff has listened closely to industry concerns to avoid imposing a standard that could have unintended consequences in terms of impacting the delivery of existing wealth management services by broker-dealers.

SEC Commissioner Hon. Daniel Gallagher emphasized the importance of proceeding quickly, but with care, in all aspects of the Dodd-Frank rule-making. He focused specifically on penalties related to the "failure to supervise" rule. He observed that, as compliance and legal staff engage more directly with advisors and traders, and bring expertise and experience to bear on specific problems, the more likely these professionals

will be viewed as having a supervisory role in these matters, implicating them in any potential wrong-doing. This outcome has a chilling effect on proactive engagement by compliance personnel in resolving potential problems. Gallagher argued for a version of a bright-line test between active involvement in compliance matters and formal supervision.

**Organizational Innovations at the SEC**

In various presentations the SEC staff described innovations in operations to improve effectiveness in the rule-making process and enforcement. The Commission has toughened compliance and enforcement in several ways. First, the national examination process has been overhauled, focused on a risk-based targeted approach relying on technology and quantitative analysis to identify potential enforcement actions in the industry and within firms, and on intra-agency consultations. In this regard, the SEC has established a Division of Risk, Strategy and Innovation integrating traditional legal and accounting staff with economic and financial experts. Division staff plays a key role in gathering relevant data and analysis to help identify potential compliance problems in the industry to focus the examination process. The SEC indicated that it would move forward with a consolidated audit trail real-time reporting mechanism to reconstruct trading patterns to identify front-running and inside trading. The initiative would begin with equity trades and then move to fixed income markets.

The Division also plays an important role in the rule-making process, probing relevant academic literature, reviewing experience in foreign jurisdictions and implementing "pilot projects" to measure the impact of proposed rules. An example is the work in developing rules for executive compensation.

The staff was asked where the line is drawn between formal notification of deficiency and an enforcement action. While the decision depends on the facts and circumstances, staff looks to see if there is a robust risk assessment/management process in place and effective oversight of operations, and whether the firm has a culture and incentives for good risk governance and control.

The SEC has established an Office of the Whistleblower with eight professionals to identify and assess tips of rule infractions. Successful tips resulting in convictions qualify for an SEC bounty of up to 20-30% of the financial penalty or settlement. The SEC Whistleblower Office coordinates with whistleblower programs of individual U.S. corporations.

**What does all this mean for IIAC?**

The SEC Speaks seminar underscored the challenging rule-making and enforcement agenda of the Commission. First, regulatory reforms flow from the inter-agency Dodd-Frank rule-making exercise, as well as independent initiatives of the Commission, and are directed at retail and institutional equity markets, corporation finance, and the OTC derivatives markets. Second, the SEC has introduced many risk-based targeted techniques for better surveillance and enforcement of market



activity. Third, the Commission has integrated technology and financial analysis through greater interaction of staff and establishing the new Division of Risk, Strategy and Innovation to ensure rule-making meets the objectives of investor protection and well-functioning markets, and surveillance and enforcement are strengthened through relevant quantitative information and financial analysis.

The staff presentations suggest the Commission understands the realities of the global marketplace and will take a cooperative approach with foreign regulators to determine comparability of regulation in order to ensure appropriate investor protection and market efficiencies, while mitigating the extraterritorial impact. The institutional make-up of the traded debt and OTC derivative markets give further credence to this approach.

The IIAC will continue to engage with U.S. regulators on behalf of the Canadian securities industry on U.S. regulations that impact Canadian dealers and the Canadian marketplace. More than ever, Canada needs a national voice on behalf of the Canadian markets to engage directly with SEC staff to argue for regulatory comparability and recognition of Canadian rules for the OTC derivatives market. IIAC will remain a strong advocate of a national securities regulator.

Yours sincerely,

A handwritten signature in black ink, appearing to read "I. Russell", with a long horizontal flourish extending to the right.

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