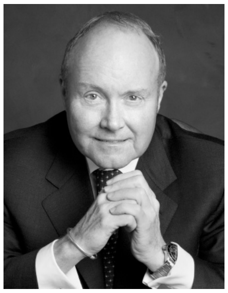
INVESTMENT INDUSTRY ASSOCIATION OF CANADA



Reconsidering Orthodoxy: Finding a Path to Better Regulation and Renewed Economic Growth

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Among both presenters and delegates at the annual conference of the International Council of Securities Associations (ICSA), much of the discussion focused on the same thing – shortcomings in the global reform process. What was evident at the conference was an erosion of optimism about achieving a global regulatory framework that will lead to needed efficiencies and integrity.

The agenda for the 2013 ICSA Annual Conference covered the broad waterfront of issues focused on securities regulation and public policy that impact the securities industry in global markets. The Conference presentations related mainly to the work of the G20 participating countries, and the key regulatory authorities in the major jurisdictions responsible for managing and coordinating the G20 policy and regulatory agenda.

Discussion points included the following:

1. Increasing evidence of the failure to produce harmonized regulation among participating jurisdictions based the G20 agenda, and the difficulties addressing inconsistencies in regulation. These difficulties reflect unrealistically tight time-frames for implementation, complexity of the reforms themselves, and limited cooperation among the four key over-arching global organizations responsible for the reform agenda: the G20 Group, EMIR (European Markets Infrastructure Regulation), Basel III and the U.S. Dodd-Frank legislation (SEC and CFTC, or Commodity Futures Trading Commission). What is the likely outcome of this disjunctive rule making? Potentially, serious unintended consequences in global OTC derivatives markets, taking the form of rising financing costs; reduced transactional flows and market liquidity and the proliferation of clearinghouses that would increase regulatory arbitrage, reduce securities netting opportunities and limit clearinghouse membership to cover securities default. It is unclear whether the other major components of the G20 agenda, such as shadow banking rules and resolution systems for "too big to fail" banks, would be implemented in a more consistent fashion.

2. Evidence that regulators, notably in Europe, have disregarded policy principles and conventions to impose priority initiatives. The prime example under discussion at the conference was the EU Financial Transaction Tax. The tax, as proposed, does not embrace the principle of tax neutrality; given the absence of a market-making exemption, the tax falls heavily on intermediaries and will have a debilitating influence on market efficiency and liquidity. The tax is unprecedented in its extraterritorial scope, applying to non-resident investors and to EU-member securities traded outside the EU markets.

3. The failure, five years on from the 2008 global financial crisis, of regulators to anticipate another crisis of global dimensions, the Libor scandal. The unfolding Libor debacle has been well publicized in the U.K. media, with major banking institutions in London admitting culpability. The scandal is now engulfing U.S. capital markets, with the potential to bring a level of controversy and publicity, and punitive consequences for U.S.-based financial institutions that surpasses the earlier global financial crisis.

4. The continued tendency of regulators to focus rule-making on the question of how to regulate, rarely asking why they regulate. The typical regulatory focus has been to identify and formulate rules and principles striking the right balance between achieving public interest outcomes and the loss of market efficiency. Even with this objective, regulators have struggled to apply proper cost-benefit analysis and other methodologies to determine the necessity and effectiveness of proposed rules to ensure cost-effective regulation and avoid deleterious consequences.

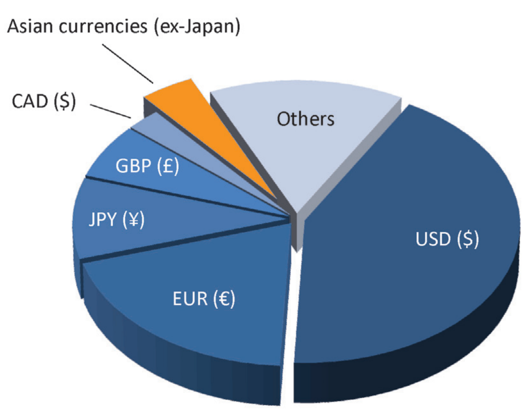
   However, in the wake of the Libor scandal there is increasingly the view regulators must move beyond specific rules and principles to achieve better alignment between stated values and the values financial institutions actually practice. Regulators must of course continue to rely on *core* rules and principles, but also must begin to judge culture *at the firm level*. This means that regulators move away from mechanical box ticking to a more holistic approach to compliance, and give firms with different business models much more flexibility in meeting compliance requirements.

Hector Sants, recent former Chief Executive of the FSA, has argued that a firm's culture is all-important in the way firms operate in the marketplace. Sants famously pointed out it was impossible for principles-based regulation to work when those charged with informal authority to maintain the integrity of the system have no clear principles[1]. By the same token firms should be able to articulate their indigenous culture, the framework for measuring and maintaining that culture, and how it helps achieve the right outcomes. Ironically, the FSA had developed a framework to measure and evaluate firm culture, just at the time the Libor scandal unfolded.

Global OTC Derivatives Markets: Multi-jurisdictional Rule-making Increasing Inefficiencies and Weakening Liquidity

Based on the evidence coming to light, the multi-jurisdictional rule-making agenda in the OTC derivatives market is creating the prospect of widespread unintended consequences that will damage liquidity, particularly in emerging markets. For example, the higher capital requirements under Basel III are causing some institutions to pull back trading operations from emerging markets (such as Credit Suisse operations in Taiwan). As well, the substantial capital required to meet clearinghouse default obligations for clearinghouses not qualified by CPSS (Committee on Payment and Settlement Services) will deter participation in these markets. (Clearinghouses in Korea, China and India are non-CPSS qualified.)

Most Traded Currencies
Percentage shares of average daily turnover



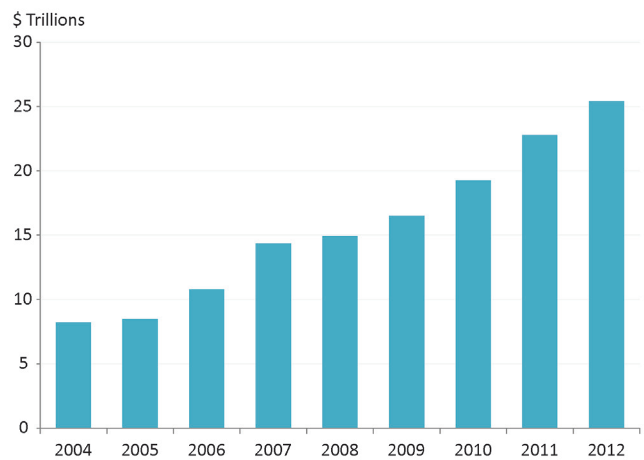
Source: BIS, *Triennial Central Bank Survey*

While the CFTC rules under Dodd-Frank permit ringed-fenced foreign affiliates of U.S. firms to deal with non-CPSS approved clearinghouses, the resulting inefficient funding transactions become expensive, discouraging such activity by U.S.-registered financial institutions. ESMA (European Securities and Markets Authority) is even more restrictive, requiring EU-registered institutions to clear only through ESMA-registered clearinghouses. Further, ESMA registration is a high bar, with recognition based on "exact equivalence", tantamount to ruling out Asian clearinghouses signing on for ESMA registration. Moreover, there are no exceptions for ring-fenced affiliates as in the U.S. Finally, and particularly worrisome, is the fact ESMA has no provision for "no action" letters that could provide some temporary relief from the rules until a regulatory solution can be worked out. The fact ESMA doesn't recognize U.S. clearinghouses unless the U.S. clearinghouses meet the rule equivalence test, an unlikely occurrence, means European institutions will be unable to join a U.S. clearinghouse.

Eliminating Cross-currency Swap Transactions Raise the Cost of Capital and Financing Risks

The capital rules imposed by the European and U.S. regulators for uncleared swap transactions are excessive. These rules will effectively eliminate most cross-currency financings through hedged swapped transactions, forcing issuers – particularly in small and mid-sized jurisdictions – to rely on bank financing, unhedged foreign currency financings or local currency offerings, all options raising the cost of capital and financing risks for issuers. Data from the clearing entity DTCC reveal that as of January 2013, there were approximately 207,500 transactions outstanding in the cross-currency swap market, with a notional amount of $16.9 trillion[2] .

Growth of Cross-Currency Swaps
Notional amounts outstanding



Source: Bank for International Settlements

[1] Hector Sants, *Delivering intensive supervision and credible deterrence* (Speech delivered at Reuters Newsmaker Event in London, March 12, 2009), http://www.fsa.gov.uk/library/communication/speeches/2009/0312_hs.shtml

[2] ISDA, *Non-Cleared OTC Derivatives: Their Importance to the Global Economy*, March 2013, http://www2.isda.org/news/isda-publishes-paper-examining-non-cleared-otc-derivatives-and-their-importance-to-the-global-economy

IOSCO: A Positive Agenda – But Can They Deliver?

IOSCO, as the international organization for securities regulators, offers the best forum and mechanism to alleviate the inconsistencies in global regulation, notably the G20 regulatory agenda. This requires IOSCO to set the appropriate agenda. First, the organization must move beyond its member-driven roots and focus on more effective decision-making. It must become a "member-directed" organization where policy decisions can be made at the staff and secretariat level, not requiring full member consensus[3]. It must effectively stop operating as a typical multi-lateral institution. While it may not have enforcement powers to achieve compliance with proposals, peer review is still an effective instrument.

Second, the organization must have an operational focus. Newly arrived Chairman Greg Medcraft and Secretary General David Wright have identified regulatory harmonization as a priority item (together with promoting market-based financing and developing emerging markets). IOSCO has established a Task Force on Cross-Border Regulation to examine the options in its "toolkit", consisting of mutual recognition, substituted compliance, dual registration and passport; identify mechanisms to facilitate rule comparability across jurisdictions, such as benchmarking against global standards or principles; and develop methodologies to assess supervisory and oversight standards.

IOSCO also recognizes that it is as important to be in the front of the rule-making process as behind it. To this end, IOSCO is establishing global principles in advance of jurisdictional regulations to provide direction to the rule-making exercise and achieve greater consistency in the rules. Some of the targeted areas include the disclosure requirements for retail-directed complex structured products, high frequency trading, regulations for shadow banking, and OTC derivatives. It remains to be seen how effective IOSCO will be in executing this well-meaning agenda.

The G20 Policy Challenge: Achieving Consistency Without Consensus

The G20 group has a massive agenda coordinating and directing macro-economic policy and securities regulation in a global economy mired in slow growth levels, continued fiscal crisis and slow-moving regulatory reform. Consensus decision-making may be difficult to achieve, particularly at a time participating countries are experimenting with less orthodox monetary and fiscal policies to break out of the doldrums of economic stagnation and malaise. For example, many central banks are adopting a more flexible approach to inflation targeting, providing greater stimulus for the economy, counting on having sufficient time to engineer a reversal in policy direction if growth suddenly accelerates. Further, many jurisdictions are less convinced of the merits of fiscal austerity, as well as wary of the social consequences, despite much evidence that expenditure cuts are more effective and less economically costly than tax increases to restore budgets to surplus. Moreover, stepped-up spending will likely have limited effectiveness, given the structural rigidities in product and labor markets in many economies.

The G20 has focused on the importance of infrastructure spending to provide short-term stimulus through productivity enhancement. The key will be whether jurisdictions can establish effective public-sector infrastructure banks to identify the right projects strictly on their economic merits, and design effective public and private partnerships.

The G20 will keep its focus on improving bank capital and liquidity standards, and designing effective resolution mechanisms for "too big to fail" banks. The G20 will continue to rely on the three key cross-border authorities, the Dodd-Frank legislative process driven by the CFTC and SEC, Basel III, and the European regulatory agenda managed through EMIR and MiFID 2 (Markets in Financial Instruments Directive) to drive the rule-making in the OTC derivative markets, shadow banking markets, and the resolution framework for troubled systemically important banks. As stated above, optimism has faded that this rule-making process will be properly coordinated to avoid serious global market inefficiencies and reduced liquidity and trading.

Conclusion: A Search for Consistent Public Policy Solutions

Global policy-makers and regulators face the serious challenge of extricating their economies from endemic slow economic growth, filling the existing gaps in securities regulation, avoiding persistent financial calamities and reducing the risks of unintended consequences in global markets from regulations that are inconsistent from jurisdiction to jurisdiction. These policy-makers and regulators must be open to new ideas and approaches and, perhaps more importantly, persevere in finding effective decision-making mechanisms to identify and implement consistent solutions to public policy and securities regulation.

Yours sincerely,

Ian C. W. Russell, FCSI
President & CEO, IIAC
June 2013

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[3] Greg Medcraft, *Challenges and strategies for IOSCO* (Speech by the Chairman of International Centre for Financial Regulation in London, September 14, 2012), http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/Challenges-and-strategies-for-IOSCO.pdf/$file/Challenges-and-strategies-for-IOSCO.pdf