Letter from the President

So What is Happening in International Regulatory Circles? A Perspective from the Annual IOSCO Stakeholders Meeting

July 1-2, 2014

Vol. 76

Globalized markets require global cooperation – among regulators and between regulators and stakeholders. That is why I was especially pleased to participate in the IOSCO Stakeholders Meeting on July 1-2 in Madrid as Chair of the International Council of Securities Associations.

IOSCO, the International Organization of Securities Commissions, is the organization representing securities regulators from around the globe. IOSCO provides a forum for regulators to discuss and debate policy and regulatory response to emerging market and institutional developments in global and regional markets. It also provides regulatory and structural support to assist emerging countries, a rapidly growing and increasingly important IOSCO constituency, build their capital markets to finance investment and economic growth. This agenda takes on more importance as anticipated retrenchment of global banks from regulatory reforms means these emerging economies will rely increasingly on their capital markets to fund economic growth.

IOSCO is led by Chair Greg Medcraft, who heads up the Australian Securities and Investment Commission (ASIC), and Secretary General David Wright. Howard Wetston, Chair of the OSC, is an IOSCO Vice-Chair, and has provided strong leadership and direction to the international organization in recent years. Particularly important to Canada, Howard is a member of the IOSCO Task Force on Cross-Border Regulation. More about that later. Bill Rice, Chair of the ASC, and Louis Morisset, President and CEO of the AMF, are also actively involved in the IOSCO regulatory agenda.

The large Board of Directors and sprawling membership bequeaths IOSCO a sweeping agenda of regulatory issues. The key strategic objective of the IOSCO Board and management is to prioritize the issues and marshal support for the focused agenda. Even with efforts to narrow the agenda, IOSCO inevitably faces a large and growing list of regulatory challenges, reflecting the dynamic and innovative nature of financial markets, and diverse interests of its membership.

Identifying and Mitigating Risks

The starting point for the IOSCO strategic focus is to identify the emerging risks in global markets through a recent survey of market participants. Some of the key market risks that have emerged from the latest survey include the regulatory uncertainty flowing from the G20 directives as well as the expanding list of regional and local regulatory initiatives, concerns about threat to cyber-security, continued vulnerability of the systemically important banks reflecting poor quality legacy assets remaining on their balance sheets, and withdrawal of risk capital from emerging markets in response to tightening monetary policy and rising interest rates in the developed economies.

What sometimes is forgotten in this forward strategic thinking are the landmark successes achieved by IOSCO in recent years. The IOSCO principles for credit-rating agencies were the catalyst that resulted in broadly based cross-jurisdiction recognition of credit-rating agencies, enabling credit-rating agencies and the securities they rate to be recognized and traded in foreign markets. Second, the IOSCO principles for the computation and dissemination of financial benchmarks have now become the standard adopted in global markets.

Cross-Border Regulation

The cross-border regulatory agenda has become a top priority for IOSCO. The extensive effort to regulate trading and clearing of securities in OTC derivatives markets has been held up as the archetypal case of poor coordination among domestic regulators, resulting in different and sometimes conflicting rules and requirements for similar trading and clearing transactions across jurisdictions, adding unnecessarily to compliance costs and market inefficiencies, and fragmenting what had been a closely-linked global market in OTC derivatives. The outcome is particularly disappointing given the commitment of the G20 leaders expressed at the G20 summit in 2009 “to raise standards together so that our national authorities implement global standards consistently in a way that ensures a level playing field and avoids fragmentation of markets, protectionism, and regulatory arbitrage."

The regulatory framework for OTC derivatives markets encompasses the foundation of data repositories for derivative transactions, registration requirements for swap dealers, mandated electronic trading (on Swap Execution Facilities, or SEFs), rules for mandated clearing through Central Counterparty Clearing (CCPs), and capital requirements for cleared (CCPs) and non-centrally cleared derivatives. The problem is the result of insufficient effort among regulators to discuss proposed rules and reach consensus on structure and format, as well as the intention of some jurisdictions to pre-empt the rule-making exercise and force acceptance of this early-formatted rule framework.

Instead of close harmonization, rules for electronic trading, registration requirements and mandated CCPs have evolved independently in different jurisdictions. As a result, many swap dealers registered in the U.S. are not permitted to clear through CCPs registered in Europe, and vice versa. This rule incoherence has transformed an integrated trans-Atlantic market into separate regional markets. For example, Euro interest rate swaps between U.S. and European parties have fallen from 25% of the market to 6%. Further, most non-U.S. registered swap dealers have stopped dealing with U.S. clients. Moreover, these rule differences mean that both U.S. and European dealers cannot transact through Asian clearinghouses, resulting in the collapse of trading volume and liquidity in derivative and cash markets in these emerging markets. Finally, now that trading through SEFs is required, market participants have indicated through recent surveys that, while transparency may have improved, transaction price, liquidity and ease of usage are worse than before.

The most straightforward exercise of all should have been the creation of a global trade repository for OTC derivatives that would provide global traded volume in these securities to regulators and central banks. But the objective of a single global repository has failed because the lack of regulatory coordination has been replaced by a series of national and regional repositories with differing aggregation methodologies and systems. That outcome makes the compilation of global traded volumes impossible.

IOSCO concludes the status quo approach leaving it to individual jurisdictions to develop and coordinate rule-making for global market activity is ineffective. Moreover, IOSCO recognizes it will never have the binding authority to impose and enforce a global rule framework. This leaves IOSCO the option to design an agreed-upon formal framework for: regulatory consultation and coordination among governments and regulators; development of guidelines to assess equivalence in rules; supervisory oversight and enforcement standards; agreement on timelines for rule implementation; design of mechanisms to recognize regulatory standards; and formation of a dispute resolution mechanism to resolve jurisdictional differences on regulatory comparability. On balance, IOSCO is optimistic about the prospects of forging ahead with this agenda. It has already facilitated 13 MOUs among jurisdictions on comparable standards for regulatory supervision.

IOSCO has established a Task Force that will issue a consultative paper on the cross-border model for cooperative rule-making and regulatory recognition, likely this September, seeking comment from market practitioners. IOSCO will then issue a final report to coincide with the G20 meetings in Brisbane in November. IOSCO has already given much thought to the project, convening three consultative sessions with the global buy-side and sell-side last April and May in Hong Kong, Washington and London.

Cross-Border Regulation Forum

A group of industry associations and individual global institutions have established the Cross-Border Regulation Forum (CBRF) to provide an ongoing industry consultative process with IOSCO. The International Council of Securities Associations (ICSA), chaired by the IIAC, has been designated as the Secretariat for the CBRF. To date, the CBRF has released a paper on the high-level principles related to cross-border regulation, and a detailed Report that i) responds to questions posed by the IOSCO Task Force in its three consultative sessions, and ii) identifies several problem areas in global OTC derivatives markets. The CBRF Report[1] makes three key recommendations for improving cross-border regulatory coordination effectively summarized in *Regulation Asia* by Ken Bentsen, President and CEO of SIFMA, recently appointed to lead the Global Financial Markets Associations (GFMA): *efforts to facilitate enhanced international dialogue between political officials and legislative/regulatory authorities at the initiation of policy development; international coordination amongst regulators in establishing reasonable implementation timetables for new rules; and the development of bilateral cooperation/consultation mechanisms for identifying areas of conflict and bringing together regulators to establish international solutions*.

The CBRF intends to respond formally to the IOSCO Consultative Paper released this September.

IOSCO staff anticipate the "tool-kit" for more coordinated cross-border rule-making, and mechanisms to assess regulatory comparability and promote cross-border recognition, will have relevance not just for the regulation of OTC derivatives markets, but assist in building an efficient cross-border regulatory framework for sustainable market-based financing for the non-bank sector (the so-called shadow banking system of private equity and hedge funds, securitized markets, and repo and securities lending markets). The tool-kit may even move the regulatory community closer to a global repository

1 http://iiac.ca/wp-content/uploads/CBRF-Response-to-IOSCO-Questionnaire.pdf

for OTC derivatives transactional data.

Encouraging Sustained Market-Based Financing
IOSCO recognizes that a priority for regulatory and structural reform should be a focus to encourage sustained market-based financing, in corporate bond markets and high quality asset-backed securities markets, as an alternative to bank financing, given expanding need for capital and the likely retrenchment of banks due to capital, leverage and liquidity restrictions. Corporate bond financings have increased significantly in volume, particularly for larger issuers. The problem, however, has been a reduction in secondary market liquidity, particularly in European markets, as higher capital requirements have pared back dealer inventories and market making. As a result, institutional funds have longer than expected hold periods. The thinness in traded bond markets makes valuations more difficult and leaves institutions and investors in bond funds more susceptible to losses from rising bond yields as institutions have greater difficulty adjusting bond portfolios.

IOSCO has also focused on the merits of standardized disclosure for corporate bonds and high quality asset-backed securities to broaden investor interest, improve receptivity for new issues and improve market liquidity. Standardization in disclosure is particularly important given the abuses in asset disclosure and related risks in the financial crisis. Securitized markets have been largely dormant for the past five years. High quality securitized investment products have a constructive role to play in financial markets, enabling banks subject to stiff capital and leverage constraints to increase the pace of corporate loan origination by packaging loans into asset-backed securities for resale to end-investors. Standardized practices for the disclosure of ABS securities improves interest and demand from large investment funds and pension funds.

Corporate Governance: Addressing the Shortcomings
In 2010, IOSCO developed broad principles of corporate governance. However, the aftermath of the financial crisis revealed serious shortcomings in corporate governance reflected both regulatory and criminal infractions by the large global banks across the international financial sector. These illegal activities have been widespread, encompassing trading violations, money-laundering, violating trade sanctions and the manipulation of financial benchmark prices.

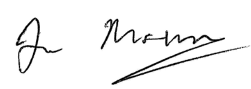
To many observers, principles of corporate governance have failed spectacularly in safeguarding ethical conduct, both at the top of the institution, and down through the operating groups of financial institutions. The evidence also shows shareholders have failed to provide a check or discipline on institutional conduct insisting on a positive culture throughout the corporation. In particular, IOSCO has identified two strategies that have taken the focus away from the long-term corporate fundamentals, the increased use of investment indexation and ultra-short hold periods reflecting the increased incidence of high frequency trading in financial markets.

Building an Ethical Culture: A Regulator's Responsibility?
While there was general consensus at the stakeholders meeting that financial institutions, particularly large corporate entities, have failed to impose a positive culture of ethical conduct and a client-first approach to business down through the ranks of the institution, there was disagreement on the needed remedial action. Some participants encouraged IOSCO to develop principles to introduce a positive culture within institutions. These principles would define responsibilities of operating groups within the firm beyond revenue generation to include risk control, the reputation of the institution and "client-first" conduct, and embrace a value-driven culture.

There was agreement that firms must define their own culture, that culture must be founded in ethical conduct, and that culture must be driven top-down as well as bottom-up. However, there was not clear consensus to move forward with this agenda, given that participants viewed culture as idiosyncratic and unique to the institution in question, and therefore left to the responsibility of individual institutions and not the regulator. Some referred to the priority to complete the extensive regulatory agenda now underway.

Conclusion: Global Issues Require Global Cooperation
The 2008 financial meltdown was a reminder of the interdependence of our global markets and a wake-up call that reforms needed to be globally integrated. IOSCO is one of the few institutions positioned to coordinate international and cross-border concerns. The IIAC is pleased to work with IOSCO to meet its agenda.

Yours sincerely,



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August 2014