HIGHLIGHTS:

The serious extra-territorial impact of the new MiFID II rules illustrates insufficient coordination among jurisdictions in rule constructs for similar capital markets activity. Indeed, jurisdictions give precedence to local and regional markets, and less to global market considerations. Individual jurisdictions also appear reluctant to defer jurisdiction to other regulators.

The recommendations of the 2015 IOSCO Task Force on Cross-Border Regulation provide an effective framework for consultation and coordination among securities jurisdictions on approaches to specific rules, assessing foreign jurisdictions on enforcement capability and supervisory oversight, and mechanisms to address differences in cross-border regulation. This proposed framework might work effectively through greater involvement of the G20 governments and the Financial Stability Board, together with IOSCO.

LETTER FROM THE PRESIDENT

Vol. 112

The need for better regulatory coordination in global markets: Some thoughts from the October IOSCO stakeholders meeting

On October 20, the International Organization of Securities Commissions (IOSCO) convened a meeting of its Board of Directors and a broad group of industry stakeholders to discuss aspects of its strategic agenda, including cybersecurity and outsourcing of financial services. This was the first stakeholder meeting in two years.

Two key conclusions emerged from the meeting discussions. The first, is that coordination in rule-making among regulatory jurisdictions could be improved to promote greater cross-border rule harmonization. Consultations could also focus on acceptable mechanisms to deal with differences in cross-border regulation. This coordination will be important as the rule-making process continues and as regulators undertake some deregulation of their rulebooks. The second conclusion, is that the risks of a steep downward adjustment in asset prices, and the feed-back effects on the global economy, are more acute than ever before, reflecting changes in investor behaviour and the vulnerabilities of the underlying global economy.

BACKGROUND

In the immediate aftermath of the 2008-09 financial crisis, the G20 directed a massive reform effort at the global financial regulatory system, focused on rules related to the trading and clearing of over-the-counter (OTC) derivative contracts to improve transparency in the derivatives markets, mitigate systemic risk and protect against market abuse. G20 Leaders agreed that all standardized OTC derivative contracts should be cleared through regulated central counterparties (CCPs); not bilaterally between the two counterparties to the trade. A frenzy of rule-making ensued. In the U.S. and UK, the reforms extended to improving prudential oversight of financial institutions given the failure and tax-payer bailouts of several prominent institutions.

The rule-making effort, however, was flawed reflecting the lack of sufficient regulatory coordination among countries in framing new rules to address similar objectives, and the failure to design mechanisms where rules differ to facilitate the cross-border flow of securities.

This meant a global market in OTC derivatives before the financial crash, became quickly balkanized as markets were forced to centre activity within regions. Global investment banks straddling multiple regions had to develop differing compliance systems for each region, adding significantly to costs. The balkanization of the global market led to less choice, less liquidity and higher costs for market participants.

In the last four years, the regulatory community, notably the Commodity Futures Trading Commission (CFTC) and EU, have worked diligently to modify rules and find approaches to recognize trading and clearinghouses outside the home jurisdiction. Some successes have been achieved. IOSCO knows this ground well. In 2013, IOSCO established a Task Force on Cross-Border Regulation to bring a more systematic and collaborative approach to rule-making across jurisdictions, and develop a toolkit of mechanisms to facilitate cross-border trade. The findings from the Task Force work revealed two things: first, close relationships among individual jurisdictions in IOSCO only went so far. When it came to rule-making the focus is intensely local reflecting regional concerns, with some jurisdictions eagerly vaulting into "first mover status" to force other jurisdictions to follow their lead. However, this approach simply truncated dialogue and encouraged other jurisdictions to go their own way with the rule-making. Second, no major jurisdiction is prepared to defer jurisdiction to another, even for limited activities in the institutional markets.

DÉJÀ VU ALL OVER AGAIN

Despite the market dislocations and inefficiencies from the 2009-12 global reforms, and the informal dialogue among jurisdictions to find ways to better facilitate cross-border trading through ad hoc adjustments, we

have come full circle committing the same failing again. After an extensive consultation process with market participants in Europe, the EU regulators have now completed the second phase of a regulatory "big bang", the MiFID II package dealing with trade execution, transparency, unbundling of fees and services, etc. Once again, in areas like transparency and treatment of research fees, the rules that will apply in the EU are different from rules in other jurisdictions, requiring foreign firms doing business in Europe to undertake the costly exercise of complying with these complex and different rules before year-end.

Beyond MiFID II, the rule-making process in debt and derivative markets will continue as U.S., European and other regulators deregulate markets to improve market functioning and capital-raising to boost growth. The fear is this process will again be uncoordinated among jurisdictions, resulting in rule changes in one jurisdiction that differ from others. While IOSCO does not have the authority to demand rule harmonization or a mechanism to facilitate cross-border trading, the Financial Stability Board (FSB), with G20 governments as members, has authority through the G20 governments to encourage national regulators to coordinate targeted rule-making with their counterparts to improve rule harmonization. In its Final Report (released September 17, 2015) the IOSCO Task Force on Cross-Border Regulation in fact stated IOSCO should engage more with the G20 and FSB to create greater awareness of the key issues and challenges faced by IOSCO members on cross-border regulation, including the need for more refined thinking on concepts of "deference". This agenda should take priority at upcoming meetings of the International Council of Securities Associations (ICSA) with the FSB.

The FSB could create an inter-active forum, including the G20 government officials and regulators, and IOSCO, to discuss the prospective rule-making agenda at the major jurisdictions, notably in institutional markets with offshore transactional flow. This exercise would provide important insights on the proposed rules, and stimulate thinking on common approaches to rules in the interests of efficient global markets. The forum could also pick up on the IOSCO work addressing how to treat differences in cross-border regulation: i) criteria to assess the enforcement and oversight capabilities of foreign regimes, and ii) application of the toolkit to reduce regulatory barriers to cross-border activity through either national treatment, recognition or passporting.

The first approach—national treatment—essentially means treating foreign market participants operating in the domestic jurisdiction in the same manner as domestic market participants in terms of market access and ongoing regulatory requirements. This would be the case regardless of the effectiveness of the foreign regulatory regime or how it may compare to the domestic one. Foreign jurisdictions, however, would be given certain exemptions from domestic rules to operate more efficiently, given their domestic regulatory framework.

The second way to manage regulatory inconsistencies is passporting—an arrangement that is based on a common set of rules, usually under international treaty or similar legal instrument, to permit market access without requirement for further authorization. The only existing example of passporting under a treaty is the EU, where a central governing body has oversight of all the states participating in the passporting agreement to provide consistent implementation and ensure harmonized supervision practices.

The third way countries could manage regulatory inconsistencies between jurisdictions is through formal recognition (i.e. deference), whether on a unilateral or mutual basis. Following the G20 summit in St. Petersburg in September 2013, G20 Leaders agreed that regulators should be able to defer to other regulatory regimes, if justified by the quality of the overseas regime. This would require an assessment of the rules and supervisory practices of the foreign regulatory regime by the host regulator to ensure it achieves similar outcomes.

IOSCO STAKEHOLDERS MEETING

At the recent stakeholders meeting in mid-October, IOSCO identified three strategic priorities aligned with its core mandate of investor protection, and organized three presentations on the topics of cybersecurity, outsourcing of services by financial intermediaries, and several aspects of investor protection: investor education, disclosure, and dealing with elderly clients. The growing sophistication and frequency of cyber-attacks is viewed as an increased threat to confidential personal information, financial loss and massive disruption to the capital markets. Presentations noted that most high profile cyber-attacks of late (notably the Equifax, SEC and Deloitte data breaches) can be traced, not to sophisticated techniques, but to neglect implementing basic elements of protection: too open-ended access to administrative controls over the technology systems and failure to place effective "patches", specifically on identified areas of the software system. The IOSCO cybersecurity agenda plans to take stock of the existing regulatory construct and best practices in place in global markets to identify possible regulatory gaps.

HEIGHTENED RISK IN GLOBAL MARKETS

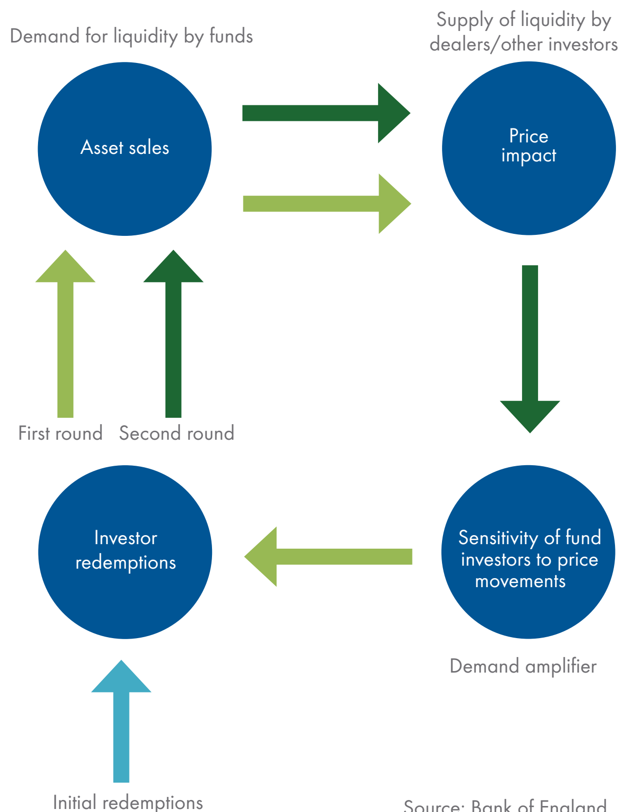
IOSCO recognizes that intermediaries have outsourced more front and back office functions to third parties to enhance efficiencies, compensate for scale and lower costs. These outsourced systems can significantly add risks as the intermediaries are responsible for the outsourced operations. IOSCO will undertake a comprehensive study to better understand the range of outsourcing services and related risks, and develop a template of good industry practices to assist regulated firms in carrying out proper due diligence and oversight of outsourcing services to manage risk.

The IOSCO stakeholders meeting did not engage the participants in a roundtable discussion of the most serious risks to global capital markets, as in past years. However, the two senior executives at IOSCO, the Chairman Ashley Alder and Secretary General Paul Andrews, commented on the risks in the global financial system in their introductory remarks. These included references to cybersecurity threats, bond liquidity concerns, the systemic market risks from asset managers in crisis conditions and the concentration of clearing risks in CCPs.

Ashley Alder described the prolonged weak economic growth in

global markets, continued high rates of unemployment, and the virtual disappearance of inflationary pressures. Central banks are winding down QE monetary policy and are set to embark on a return to interest rate normalcy, predicated on incipient signs of economic recovery in the U.S. and Europe. Poor economic conditions across the developed economies have ignited protectionism and political populism. Continued low interest rates have disadvantaged savers, but have accommodated a substantial buildup in debt among households and governments. The European debt overhang may have left the headlines, but remains an ever-present problem for policy-makers. Moreover, Europe and the UK must cope with finding an acceptable solution to Brexit. China's massive debt pile remains a concern.

While Alder provided an effective and succinct description of current economic and financial developments, he did not elaborate on implications for heightened risk in global markets. The background economic conditions Alder described increase the risk of triggering a major shock to global markets. Global financial markets are vulnerable to significant reverberations from economic and geo-political events, even though much progress has been made addressing the stability of the banking system. The dramatic shift to passive index-linked funds and derivatives (like ETFs) has concentrated trading in large cap benchmark securities. The emphasis on index-linked investment management, to lower costs and minimize risk, has caused all asset classes to move close together.



Source: Bank of England

Instead of focusing on corporate fundamentals and on valuations, financial markets have been obsessed with QE, low interest rates and the global growth and political dynamics that drive them. In addition to highly synchronized swings in asset classes and increased investment concentration in benchmark securities, the global markets have witnessed significant concentration among institutional managers to achieve significant business scale.

External shocks could trigger steep declines in asset prices. Banks and dealers have limited scope as market-makers to absorb panic selling, particularly by asset managers faced with massive exposure to falling asset prices, accelerating withdrawals of client funds as values plummet, and limited liquidity to avoid major asset sales. The accelerating collapse in equity values and steep rise in interest rates (as bond prices fall) would quickly reverberate in the real economy, pole-axing the incipient recovery, with potential for much worse. A recent Bank of England study found that weekly investment-grade corporate bond fund redemptions equal to 1 percent of total net assets under management (not seen since October 2008 at the peak of the global financial crisis) would result in an increase in European investment-grade corporate bond spreads of around 40 basis points. Redemptions of 1.3 percent of total net assets could increase spreads by around 70 basis points, which is equivalent to 50 percent of their historical average value.

It is no surprise that IOSCO and other regulators have quite rightly focused on reducing the balance sheet exposure of fund managers to falling asset prices, through such measures as limiting leverage and ensuring significant holdings of liquidity. Moreover, regulators continue to examine the liquidity of corporate bond markets under stressed market conditions.

IN SUMMARY

The extra-territorial compliance challenges thrown up by MiFID II point to the lack of effective coordination in rule-making across the major jurisdictions, particularly in wholesale markets that have global reach. The path-breaking work undertaken by the IOSCO Task Force on Cross-Border Regulation in 2013-15 to better coordinate rule-making and build mechanisms to address differences in cross-border regulation was stymied by the intense local focus of regulators, and reluctance to defer jurisdiction.

The shift to financial regulation in response to chronic weak economic growth, driven by the new U.S. Administration, suggests further rule changes are in the offing. The Financial Stability Board, with its G20 member governments and involvement of IOSCO, has the leverage and resources to build a formal consultation forum on securities regulation and drive greater rule-making coordination and solutions to address differences in cross-border regulation. This effort would complement recent positive signs of cooperation among U.S. (Commodity Futures Trading Commission) and EU regulators on margin rules for uncleared swap transactions, and lead to increased efficiencies in global debt and derivative markets. Better functioning global markets will, in turn, mitigate the significant risks in these markets.

Yours sincerely,

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November 2017