INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

Letter from the President

What's Going on in Global Reform?

Key takeaways from the annual IOSCO stakeholder's forum September 22-23

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On September 22-23, 2015, I attended the IOSCO Stakeholders' Meeting in Madrid. The lead-off speaker, Greg Medcraft, Chair of the IOSCO Board, outlined IOSCO successes over the past several years, including the development of new principles for financial benchmarks, and efforts to address cross-border regulatory challenges and support increased capacity building in emerging markets. He also set out the strategic objectives and challenges for the international organization over the next five years. Both lists contain many items, crucial to the industry and the global economy.

The IOSCO agenda

Since the 2008 financial crisis, IOSCO has been at the epicentre of global reform efforts. It is recognized as the key interlocutor for global capital markets. IOSCO:

- Has been active as a global standard-setter on credit rating agencies, developing Final Code of Conduct Fundamentals for Credit Rating Agencies;
- Created Principles for Financial Benchmarks—an overarching framework for principles used in financial markets, covering governance and accountability, as well as the quality and transparency of benchmark design and methodologies.
- Developed risk mitigation standards for non-centrally cleared OTC derivatives to improve the resilience of trading and clearing systems;
- Provided a set of factors (policy guidance) that should be considered by trade repositories in designing and operating their services and by relevant authorities in regulating and overseeing trade repositories; and
- Worked to revise the framework for margin requirements for non-centrally cleared derivatives.

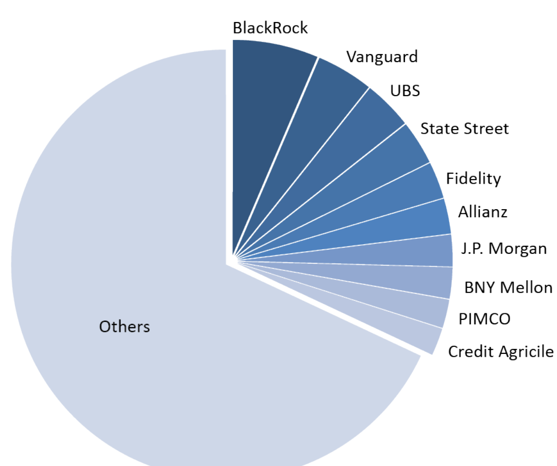
IOSCO has also been active in efforts to achieve greater harmonization in the global rule framework for OTC derivative securities, and in developing standards for securitization, SME financing and investor protection. The Organization has also been focused on developing programs targeted at emerging markets to build financial market and regulatory expertise. It has recognized that capital markets will become increasingly important in intermediating capital for productive investment, particularly as the regulatory burden on the banking system handicaps lending activity.

The Organization anticipates increased liquidity risks for buy-side institutions in markets, as central banks gradually unwind QE and market making shrinks in tandem with more restrained bank balance sheets.

It also sees the accelerating threat of cyber attacks on markets and individual firms, and is concerned about the risks of bad conduct on the reputation of the markets and individual firms, and how this would damage investor confidence.

IOSCO is concerned about regulatory issues raised by the impact of technological changes on market integrity and efficiency, and has emphasized the importance of monitoring and assessing technical innovation—or digital disruption—on financial markets and services.

Concentration in Global Assets
Top 10 managers account for a third of global AUM



Source: Relbanks, Boston Consulting Group

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IOSCO is focusing its agenda on standards to improve conduct and the culture of "gatekeepers" in financial markets, improvements to corporate governance, standards to address cyber threats to the financial industry, ongoing monitoring of technological advances and its impact on global capital markets, and efforts to build expertise and capacity in emerging markets.

IOSCO also wants to strengthen its own reputation and profile in international deliberations on global financial policy and exert greater influence over the other multi-national institutions (such as the FSB, the Basel Committee on Banking Supervision and the OECD). IOSCO is the logical organization to oversee and implement the G20 agenda on global capital markets, a responsibility that becomes even more important as more savings and investment flow through the financial markets and away from the banks.

In summary, the aftermath of the 2008 financial crisis has provided a unique opportunity for IOSCO to take a leadership role in the reform of capital markets, and it has executed its role effectively. The strength of the organization has proven to be its effectiveness in identifying the key risks in global financial markets and setting global standards for market participants. On the other hand, the Organization has found it difficult to persuade individual jurisdictions to coordinate rule-making in the interests of a harmonized rule framework, and has been relatively unsuccessful in encouraging jurisdictions to simplify the overlapping and duplicative rules confronting firms trading and clearing securities in global markets. Simply put, IOSCO does not have the power or the authority to force greater rule coordination among its members. These weaknesses have made it difficult, for example, to resolve the rule differences in OTC derivatives markets.

Changing conduct for the better: Applying sanctions, building culture

Almost seven years on from the financial crisis, "triggers for public opprobrium are plentiful," remarked Mark Carney, Governor of the Bank of England. The serious wrong-doings in the financial community after policymakers embarked on reforms have resulted in cumulative fines levied on global banks in the order of $150 billion (translating into more than $3 trillion of reduced lending capacity to the real economy), and is seen as clear evidence of bad culture embedded deeply in the global financial sector. "The repeated nature of these fines demonstrates that financial penalties alone are not sufficient... Fundamental change is needed to institutional culture," added Mr. Carney.

IOSCO has recognized that remedial action to improve conduct requires a two-track approach: applying credible sanctions on wrong-doing to deter bad behaviour, and encouraging firms to build good culture. Tough sanctions should be in place to deter bad behaviour, and rules and standards are necessary to promote fair and effective conduct, and build positive culture, with sufficient resources and procedures to oversee activity.
Culture is recognized as a key ingredient to improved market conduct. While culture can differ across firms, there are several core principles consistent with good culture:

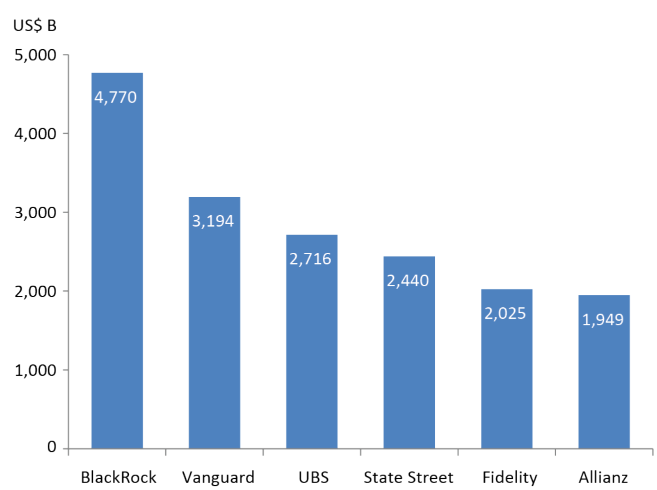
i. The right tone at the top that puts the client first, demands ethical behaviour and imposes stiff retributions for wrong-doing;
ii. Clear accountability for wrong-doing (the Fair and Effective Market Review emphasized firms taking greater responsibility for employee conduct and the most senior personnel in the firm held accountable);
iii. Clear and open communication across the firm; and
iv. Imposition of the proper incentives to influence behaviour. Firms would establish policies and procedures to ensure these principles are met.

Ensuring adequate liquidity in asset management

The growing size and influence of large asset managers and mutual funds in global markets, and the prospect of less liquid capital markets have prompted a debate on whether asset managers can access sufficient liquidity in times of stress, particularly if market shocks and client withdrawals from funds force balance sheet adjustments. Recent events, such as the 2013 "taper tantrum" (when the U.S. Federal Reserve signaled the end of its bond-buying program) and the "bund tantrum" in April/May 2015 have shown that liquidity can evaporate quickly, assets prices can gyrate widely and trades can become more difficult to execute.

There was general consensus among the buy-side industry at the IOSCO Stakeholders' Meeting that, at least in certain circumstances, liquidity is sufficient. Many institutions have taken precautionary measures, such as improved access to repo financings and strengthening bank credit lines. Further, institutions have placed greater reliance on electronic trading platforms, are splitting transactions into smaller sizes to make execution easier, and are relying on more liquid managed investments in corporate debt, such as mutual funds and ETFs, as an alternative to direct investment in bonds.

Largest Asset Management Firms (by AUMs)



Source: Relbanks

Some of the regulators in attendance had not taken a definitive position on the liquidity situation, emphasizing the need for further research and analysis, as well as stress testing.

Cross-border regulation: The challenges and the possible solutions

The financial crisis exposed significant weaknesses in the over-the-counter (OTC) derivatives market. In the immediate aftermath of the crisis, the G20 Leaders agreed to improve the integrity of trading, clearing and reporting of OTC derivative transactions. Individual regulators responded—some more quickly than others—to introduce new rules for dealers and clearinghouses in the derivatives market. The problem is these reforms were introduced without much coordination among the regulators.

The lack of coordination resulted in duplication and disparity in the rules governing similar types of transactions, and led to a fragmentation of liquidity pools in global markets. Markets have balkanized along regional geographic lines, with derivatives traders unable to execute with foreign counterparties, and clear through offshore clearinghouses, without being subject to multiple regulatory regimes. The global marketplace for OTC derivatives quickly became a regional marketplace.

The balkanization of the global market has led to less choice, less liquidity and higher costs for derivatives users.

Nations are gradually moving towards more engagement to address regulatory overlaps, gaps and inconsistencies. IOSCO noted that the increased engagement is mostly bilateral at present, but it is hopeful multilateral engagement will develop further as markets grow and emerge, and will do so with greater use of Memoranda of Understandings—MOUs—between participating jurisdictions.

The Final Report of the IOSCO Task Force on Cross-Border Regulation was released on September 17, 2015. A key mandate of the IOSCO Task Force on Cross-Border Regulation was to provide greater cross-border access to domestic or regional OTC derivatives markets through various approaches to relieve or reduce regulatory obstacles. The Task Force identified a broad tool-kit comprised of three approaches to reduce the regulatory barriers to OTC derivatives markets—namely, national treatment, passporting and recognition.

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. Foreign jurisdictions, however, would be given certain exemptions from domestic rules to operate more efficiently, given their domestic regulatory framework.

Passporting is 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 jurisdiction is through formal recognition (i.e. deference), whether on a unilateral or mutual basis. Following the G20 summit in St. Petersburg in September 2013, 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.

The latest Task Force Report makes a series of recommendations for IOSCO to undertake:

i. Integration of the cross-border dialogue into all policy work to identify potential cross-border problems as part of the policy-making process;
ii. Organization of workshops for regulators on specific aspects of the cross-border regulation. These workshops would be particularly helpful in fostering better cooperation among regulators to achieve greater harmonization in the rule-making process: and
iii. Information repositories for supervisory MOUs and any decisions on regulatory recognition

The biggest obstacles to implementing an effective cross-border agenda is the deep reluctance among jurisdictions to outsource responsibilities, notably investor protection, to a foreign jurisdiction; to give up sovereignty; and to import bad financial products and bad conduct, made graphic in the last financial crisis.

On the other hand, the failure of individual jurisdictions to cooperate on rule-making process and resolve key differences in rules and regulations reduces the efficiency of global markets, fragments the marketplace and raises the costs of compliance and doing business.

There is a risk that the cross-border objectives of the Final Report of the IOSCO Task Force will be subsumed under the general policy work of IOSCO. The IOSCO cross-border agenda would then lose momentum and priority. This would be most unfortunate. IOSCO is the only international organization capable of tackling and resolving the cross-border problem.

The solution may be to find a way to integrate the political process, namely the G20 Directive and the commitment of the participating governments to harmonize rules and regulations, directly into the rule-making and harmonization exercise managed by IOSCO. Doing so would put pressure on individual regulators to work constructively through bilateral or multilateral negotiations to resolve the cross-border regulatory obstacles stemming from an overlapping rule framework.

IOSCO would play a key role in encouraging the G20 to be more pro-active; identifying the most serious cross-border regulatory impediments; developing more granular criteria for regulatory recognition; establishing a framework for bilateral and multilateral negotiations; and managing the negotiating process among the participating jurisdictions. In turn, the participating jurisdictions would agree on the desired regulatory outcomes and would rely on international regulatory benchmarks (such as the IOSCO Objectives and Principles of Securities Regulation) for comparative analysis and to measure progress on removing obstacles to cross-border transactions. It is only through an organized and focused process that headway can be made on improving the efficiencies of global markets.

If the G20 and IOSCO can initiate bilateral or multilateral negotiations on the key cross-border regulatory impediments to capital flows, the successful outcome of these negotiations could trigger a positive response from the other small jurisdictions, like Asia Pacific countries, that have delayed rule-making and are on the sidelines. The negotiations would provide these jurisdictions with greater clarity on the direction of cross-border harmonization of derivatives regulation.

Yours sincerely,

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