Panel 3

"Financial products: What supervision? What notation? What guarantees?"

Moderator:

Isabel Martin Castellà, Managing Director, Madrid Centro Financiero Internacional, Madrid

Speakers:

Ronald W. Cornew, President, Market Consulting Corporation, Miami

Jesús Gonzalez Nieto, Market development Director of the Madrid Stock Exchange, Coordinating Director of Latibex, Madrid

Greg Pollock, President and CEO, Advocis, The Financial Advisors Association of Canada, member of the Federal Government's Task Force on Financial Literacy, Toronto

Jacques Potdevin, Former President, Federation of European Accountants (FEE), Brussels

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In a few introductory words, the moderator Isabel Martin Castellà underlined the favorable position of Madrid, the host city of this conference, as an international financial center. She said that studies commissioned to consultancies such as Deloitte and PriceWaterhouseCoopers, as well as various international rankings, found that Madrid was the fourth largest financial center in Europe, and offered a good location for finance. Spanish banks, she said, are the most efficient in the world in terms of cost to income ratio.

In starting his address, Jacques Potdevin stated that he was a practitioner and focused on day to day aspects. He remarked that to understand this crisis one has to see that one key element was the fact that there was too much liquidity, driving the interest rates of regular investment products down. So in order to seek higher yields, investors were keen on using special products providing higher interest rates but associated with higher risks.

In direct link with the panel's title, Mr Potdevin noted that, while he was representing the accounting profession at the European level, he was impressed to discover that 50% of the funds in the world are based in countries where there aren't any kind of financial regulation. And 50% of the transactions happen outside the market, which greatly increased risks. Talking about tax heavens, he asked: "was it necessary to mix the idea of having low taxes with having no transparency at all about the funds and their movements?". For financial advisors, he noted, it becomes ever more important to know where the client's money comes from, if it is from countries on the white list or the gray list of the OECD. Even though many countries in the gray list are in South America, some are in Europe as well, such as Belgium.

So what has been the response of governments to this lack of international regulation and supervision? Unfortunately, the standard response of governments

has been to try to raise the controls of people living in their country, said Mr Potdevin. He took the example of France, where the government's response has been to create a database to inventory all bank accounts owned by French individuals or companies around the world, in order to be able to interrogate the countries where these accounts are held on the transparency of the transactions made on these accounts. Of course there is a fiscal interest in doing so, but not only. So the government's response so far is not to try to limit the risks of loss of investors and savers, but to try to better control the circulation of funds. The assumption being that by controlling the fund circulation they will be able to limit the financial risks. "I am not sure this is the best approach", said the panelist.

When you create such an information system, you need also to create a system to control it. So France introduced, like in Italy, a fiscal police. It has nothing to do with fiscal control, it is merely designed to track down financial operations for various risks, in particular money laundering. So from a macro-economical regulation, we are now moving towards a micro-economical regulation. Does this solve the problem? It doesn't address the real issues, which is speculation, said the panelist, especially on hedging products. These products, which played a large role in the financial crisis, were initially invented for protection purposes. But then they have been used for speculation, and the problem today is that these instruments do not require any deposit, as they did historically when they were introduced. "You can speculate with huge amounts without having any deposit to cover your transactions", detailed the speaker. So in order to rein in speculation, if not to stop it, minimum deposit requirements must be introduced at the international level. By setting the level of deposit requirements, you can control the level of risk, said the panelist. "So if we are able to set a reasonable deposit ratio, maybe we can better regulate our financial systems. Otherwise, I am afraid that we will have another huge crisis, larger than one we have just been through".

Jesús Gonzales Nieto then talked about about the role of Exchanges in providing transparency, an thus stability, in financial transactions. "Transparency is the core concept of any market and the basis of trust", he said. In order to make markets more efficient and secure, there must be transparency in the formation of prices, but also in post-trading, as well as in the costs of trading.

In this respect, the Spanish Exchange has played a pioneering role in Europe by being one of the first Exchanges, together with Paris, to introduce an electronic trading system, as soon as 1989. This system introduced much more transparency and equality of treatment for all market participants, whatever their size, noted Mr Gonzales Nieto. With this system, a small investor could have priority of his order over Morgan Stanley if his order was put even just a millisecond before the one of the large bank, at matching price.

At this time this was revolutionary, and despite the critics such systems have now been implemented by all trading systems, and this philosophy is the essence of the various European financial directives. Yet with the development of off-exchange trading, various aspects of transparency in pre-trade, costs, best execution and price formation get disrupted to various degrees. Which counters the efforts of supervision and fair treatment of the investors sought after by the MiFID, the European directives on financial transactions.

A critical value of Exchanges is in the area of transparency over costs. The

investors trading on an Exchange knows which costs incur to him, as compared to other trading platforms. Apparently, the trading fees, the explicit costs, are more favorable on other off-exchange trading platforms, so-called dark pools, or what the European directive calls MTF, "Multilateral Trading Facilities". Fees on these MTF are half those of traditional Exchanges. But the implicit costs, i.e. the bid-ask spread supported by the investor, is much larger, and not transparent at all. "This is something that in my opinion escapes the scrutiny of the European regulator, said Mr Gonzales Nieto. And obviously large banks and financial institutions which have the power to divert some of the transaction streams of their clients to off-exchange platforms openly take advantage of this non-transparent spread in their favor".

The objective of MiFID, said the panelist, is to promote competition between markets in order to achieve better services at lower costs for the investor and companies. "The risk after many years of MiFID implementation is that we cannot demonstrate that the global transaction costs, made of direct explicit costs (fees) and indirect implicit costs (spread), would diminish. I think on the contrary". Also, it becomes very difficult to determine another fundamental rule of MiFID, which is best execution. Best execution only works if at all times an investor can know exactly that his order has been executed at the best spread and the best price. "Today in Europe, the way the markets are structured, this is simply impossible to guarantee", analyzed the speaker.

A third point of problem with the development of off-exchange platform, and potentially even more dangerous is the issue of price formation of stocks. Price formation depends on supply and demand, i.e. how many agents are able to concentrate their orders at the same time over one transaction. The risk, by diverting some stream of transactions off-exchange, is one of fragmenting the market, which affects the price formation of transactions. This is especially problematic for stocks that are less liquid, where few transactions get spread over different trading systems. What results is a need to arbitrate between systems, which makes trading more complicated and costly. So as a result of market fragmentation, the ask-bid spread tends to open. This effect may be small and seem acceptable for highly traded and liquid assets, but it becomes quite large for small, less traded assets, commented Mr Gonzales Nieto. Adding: "I believe that these aspects are not analyzed with enough scrutiny by the European regulator. And I basically think that the trading platforms today in Europe do not offer rules that are really fair and balanced for the investors. And I will add that even on the supervision level the rules are not optimal. The MiFID has allowed that an important part of the stream of financial transactions occurs off-exchange, meaning off-regulation and without much transparency".

To illustrate this point, the panelist showed a graph of the distribution of trading in Europe in 2009, according to the estimates of the FESE, the Federation of European Stock Exchanges. It showed that only 50% of the trading in Europe occurs through regulated markets, i.e. traditional Exchanges, which are the only ones offering a guarantee of transparency and supervision. 38% of transactions take place completely outside of Exchanges in the form of OTC (Over The Counter) transactions. "This includes all the large investment banks in Europe, which use this system intensively for clients who tolerate this complete lack of transparency – for reasons I just cannot understand", said the speaker. Another 10% of transactions occur on MTF platforms, or dark pools, such as the Turquoise or Chai-X platforms.

And finally an estimated 2% is done through internalized trading, another concept in which large banks match the transactions among their clients without ever using an Exchange. "You will understand in which position is the bank and which position is the client", said Mr Gonzales Nieto. Yet no one talks much about the 38% of OTC transactions. The MTF, or dark pools, get a lot of attention, but this is not worrisome as these platforms are supervised and have levels of transparency somewhat comparable to Exchanges, said the speaker. "The real problematic issue is pure OTC, which is not supervised and lacks transparency".

So an important contribution that Exchanges can provide is in the area of transparency for investors, and also in supervision, including preventively in protecting investors by providing them with information and training. Since 20 years, the Spanish Exchange has had an ombudsman to deal with issues between banks and investors, which brings an important factor of trust. Also, the Spanish Exchange provides training to investors though an institute called BME, with thousands of people taking courses each year. It also offers "Infobolsa", a financial information provider more adapted to the needs of small investors.

Ronald Cornew then discusses in particular the question of supervision from the panel's title, giving the audience an overview of the latest developments and trends in financial regulation and supervision in the US. He further discussed the issue of convergence of regulation and supervision between the US and the EU, a necessity that was stressed by the 2010 G20 conference in Pittsburg, USA.

The panelist first addressed the regulatory actions that have already happened in the US since they do not depend upon any change in the law. First, the Securities and Exchange Commission (SEC) has implemented a new uptick rule for short selling. Such a rule existed in the US for 70 years, but was eliminated in 2007. During the recent crisis, an emergency rule was put in place to prevent any short selling. Now the SEC adopted a new rule, based on the idea of a circuit breaker, which allows short selling until the price of a stock declines 10% or more on a single day. Then restrictions of 10% each day apply to try to prevent damaging effects of short selling. This rule has been formally adopted, but the markets have been given six months to implement it, so it should be in place at the end of 2010. This new rule has come under a lot a criticism since it is not judged efficient enough, and would still allow short sellers to drive the price of a stock down 30% over a week. "For many companies that is sufficient to drive them into bankruptcy or near so, said Mr Cornew. Once you see a 20% or 30% decline in their stock, everybody will start selling them, you only need to get the process started and it is still possible to drive a company to ruination".

Further, on commodities markets, the Commodities Futures Trading Commission (CFTC) wishes to implement regulation on energy products such as petroleum in the form of position limits, in order to limit speculative pressure on prices. On off-exchanges, a new rule requires that speculators have to supply a margin equal to 10% of the value of the position they wish to take.

Then the panelist turned to regulation proposals in the US that require a change in the law. A financial regulation Bill is in the Senate, which may change many things we do in America, said Mr Cornew. First, there is a provision in this Bill for a

framework for regulating Over The Counter (OTC) derivatives. Secondly, there is requirements that restrict banks from engaging in proprietary trading on their own account, as well as affiliated hedge funds. Further, investment banks issuing products would be required to maintain a certain position in the product they create, so that they have a continuing interest in the health of these products, in order to make the securitization process more responsible. The SEC will also be given broad powers, for the first time, to regulate the credit rating agencies offering ratings on financial products. The SEC would have the power to deregister any rating agency that did not meet certain standards. The Bill also calls for the creation of y consumer finance protection agency, meant to be a watch dog looking after the needs of consumers in financial markets. "But interestingly, said the speaker, the Senate Bill places that agency under the responsibility of the FED, which does not have a reputation for being a very severe regulator. So criticism is made on the Bill for that particular point".

Finally, the Senate Bill sets out to find a way to deal with the problem of "too big to fail", of financial institutions that are so big that they can't be allowed to fail, since their failure would create systemic risk in the market. "The Bill calls for the creation of a systematic risk control counsel, which would have the ability to both monitor financial institutions to see if they might be getting into trouble, and break them up or close them down as appears to be needed", explained the panelist.

Turning to the question of parity and convergence between the European and US regulation, Mr Cornew noted at least three areas where differences are going to be difficult to resolve between what the EU has already put in place and what the US is working on. The first area is in the regulation of hedge funds. "There has been quite a squabble between the UK and the US on one side and the EU on the other side concerning whether hedge funds products can be sold in Europe and under which conditions", reminded the speaker. The point raised by the EU being that, in order to comply with its regulation, funds should not only have their management located in the US or UK, but it also depended on where the company itself was located. And since many of these funds are located in the Cayman Islands, they would not qualify to be sold in the EU".

A second area of differences concerns derivatives speculation, in particular OTC derivatives. "There is not a dark pool, but a dark ocean of such derivatives being traded today", noted the speaker. The Bank for International Settlement estimated the amounts of OTC derivatives in 2008 at 680 trillion dollars. "After trillions, we are now talking in terms of over half a quadrillion dollars", emphasized Mr Cornew. "OTC derivatives were an important factor in the Greek situation, and one we absolutely have to get on top of", he added. According to Mr Cornew, there has to be much more visibility in what is happening in these transactions, and a lot could be standardized and, if not traded in exchanges, at least cleared through a clearing house rather than through the kind of bilateral arrangements that currently exist. "When you bring a clearing house in the middle of transactions, you take out the worry about whether your counterparty is safe or not. In the US we have had a central clearing of future exchanges since about 1860, and there has never been a single failure of a clearing organization that meet the obligations of the parties who might have failed individually", declared the panelist, concluding: "In this area as well we need a convergence between regulation occurring in the US and in the EU".

Finally, the third area of difficulty, yet necessity, in convergence of regulation is the issue of size and capitalization of banks with regards to the "too big to fail" problem. "Some people are talking about raising the capital to asset ratio for banks in the area of 8%, said the speaker. I believe a more intelligent approach would be to have different ratios for different banking activities, and indeed even different product lines, in order to make banks safer". Yet another, more radical school of thoughts in the US, illustrated by MIT professor Simon Johnson in his book "13 bankers: the Wall Street takeover and the next financial meltdown", is that a solution to the too big to fail issue is impossible unless you break up the size of banks. As a result of the crisis, the six largest US banks got even larger, through acquisitions, and are now two to three times larger as a percentage of US GDP as they were back in the 1980s. So the idea is to bring back those banks to the size of that time. As difficult and radical as this idea would seem, it has actually support among both the Democratic and the Republican parties. Alan Greenspan, the former President of the Fed and a Republican, said very simply that "if a bank is too big to fail, then it is too big". The panelist reminded that in the US there were precedents of breaking up organizations that have become too large, such as Standard Oil or AT&T.

The speaker then addressed another area of concern which, he said, he didn't see discussed anywhere but was of utmost importance. Accounting rules, he said, should be changed to require on-balance sheet recognition of the liabilities and asset derivatives. He showed the example of the balance sheet of Citibank since 2004, showing a seemingly healthy bottom line, while in that period of time that organization lost one quarter of a trillion dollars. "Because derivative transactions do not come onto the balance sheet, because the liabilities are not reflected there, the balance sheets of a significant number of organizations are a complete fiction", said the panelist. "You cannot look at a balance sheet and in any way rely upon what you are seeing". This problem extends to the efforts described earlier for the creation of a systematic risk control counsel in the US which would have to monitor financial organizations for their risks. "They would have to be quite sophisticated in order to understand the derivative transactions in organizations involved to have any chance of carrying out that mission", commented the panelist.

Mr Cornew concluded his remarks by warning the audience that in his view, unless a lot of regulatory change occur, the crisis we have been through will recur in the future. "Indeed, I would argue that we tend to look at crisis as departure from normal situations, as abnormal and infrequent events. My sense is that the people in this room, as financial analysts and advisors, should not only realize that these things happen, but can count on them happening in the future. So the challenge is how can you structure portfolios for clients that will survive these crisis when they happen, I think with increasing frequency in the future, and at the same time construct portfolios that may even profit greatly when a catastrophe occurs".

The last panelist, Greg Pollock, gave the audience a perspective on the Canadian experience with respect to the regulation of financial products, which he called a "tale of two sectors". The speaker started by noting that of all the developed nations, Canada was the only country that has not used one penny of public funds to lend aid to ailing financial institutions. "Why? Because it was not needed", he said. Because the regulatory structure of the Canadian securities, insurance and banking

sector proved sufficiently robust to allow Canadians to share in the global economic growth experienced over recent decades while largely avoiding the excessive risk taking that put so many financial sector institutions around the world on life-support. But a past track-record of success does not guarantee success in the future, so Canada, like all its global partners, is currently reviewing how to improve the regulation of its financial sector. One of the latest developments impacting this regulatory review is the growing convergence among financial products available to consumers, as well as a convergence between financial products in the securities sector and the insurance sector. "Product developers continue to innovate, which results in securities instruments that cleverly package insurance risk for sale in the capital markets. And similarly, in the insurance sector we see traditional securities products reworked with insurance wrappers on them, thus transforming what was once a capital market product into an insurance product". And for both types of products, the independent financial advisor is the intermediary. Yet in Canada, despite this convergence, securities and insurance products are not regulated in the same way. Hence a tale of two sectors. The insurance sector regulation is guided by a principle-based approach, while the Canadian securities sector is guided by a more prescriptive and rules-laden approach. Referring to the panel's title, the speaker suggested: "In a context where the lines between insurance and securities products is unclear, we need to ask ourselves two questions: how are insurance and capital market products to be supervised, and what are the guarantees associated with these products?".

The panelist described the fundamental differences between insurance and securities products and their regulation. Generally, the objective of insurance products is protection, not financial growth. The risk is supported by the insurance company for a premium. Here regulators are concerned about solvency issues of the insurance companies. They further want to ensure that consumers are treated fairly and understand what product they are purchasing. This is addressed through conduct rules that set out in general principles how an independent financial advisor is to deal with his clients.

In the securities market by contrast, the risk is assumed by the consumer, in exchange of an opportunity of gain. Here the regulation is not intended to remove the risk associated with investing. Rather, it is intended to insure that clients are treated fairly, justly and in good faith by security registrants. Transparency plays a critical role in the capital markets, and it is achieved through mandating the use of a prospectus and ongoing disclosures, as well as implementing conduct rules for IFAs.

With regards to the regulatory reviews, Canada is moving in the direction of establishing a common securities regulator that will operate from a principle-based platform. Yet the federal structure of Canada implies that each of the ten provinces and three territories has the constitutional power to regulate the capital market within their jurisdiction. Insurances and securities are regulated by 26 different regulators. Banking, on the other hand, is centralized with the federal government. It is likely that the regulation of securities will move in the direction of a nationally focused policies similar to banking, explained Mr Pollock.

Finally turning to the guarantee aspect of the panel's title, the speaker highlighted that in Canadian banking system, bank accounts are guaranteed for up to $100 00

by the federal government. Insurances have similar standards of protection for their clients in the event that their life insurance company should fail. By contrast, securities are premised on the assumption of risk. The Mutual Fund Dealer Association, MFDA, has an investors protection corporation that can be used to provide redress. But this consumer protection fund is not intended to provide guarantees from the assumption of risk in the capital markets. What it does is guarantee that clients are treated fairly by registrants. But in the event of fraud by a non-registrant IFA, the client has no guarantee.

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