New trends in Capital Markets regulation

Remarks by Tajinder Singh, IOSCO Deputy Secretary General, at the Regional Conference on Investor Protection in Capital Markets, Mumbai, 28 – 29 October

Let me begin by thanking SEBI, BAFin, German Cooperation and GIZ for this kind invitation. It is always a pleasure to be back in Mumbai and among friends.

Allow me to mention a few words about IOSCO, the International Organization of Securities Commissions. IOSCO is the global standard setting body for securities regulation with about 120 regulator members. But IOSCO is not just about setting standards; it is also about helping members, a majority of whom are emerging markets, in capacity building; it is also about monitoring implementation; and it is also about looking at emerging risks. IOSCO's objectives are investor protection, fair, efficient and transparent markets and reduction of the systemic risk.

Given the topic "*New trends in Capital Markets regulation*", let me mention six **notable trends relevant to securities markets**:

1. ***Bank lending to the real economy has been decreasing due to*** new regulatory initiatives requiring banks to hold more capital. The situation in Europe is especially stark with lending at 50% below the 2009 levels.

2. ***Corporate reliance on securities markets has been increasing despite volatility:*** In the US (though not in Europe), equity offerings as well as corporate debt issuance

have increased 20%- 25% over 2007. Asian corporate debt issuance is on the ascent, specifically from China, as is the rise in Islamic financing. ***Importantly, there is reliance on securities markets for bank funding also, including the use of securitised products.***

3. ***Equity markets*** have experienced significant price appreciation over the last year. ***Fragmentation*** across trading venues and the participation of dark pools has increased in many jurisdictions.
4. In the search for yield, the market for ***high yield bond issuances*** has increased fivefold from $90 billion in 2008 to $450 billion in 2012. Asian bond markets have been particularly active in 2013.
5. Since the crisis, global regulation has caused ***OTC derivatives markets*** to undergo important changes; there is good progress in trade reporting and central clearing.
6. ***Capital flows in emerging markets*** have increased substantially since the financial crisis.

Coming back to the issue of growth in an environment with constrained credit ability, it is clear that securities markets will have to play an important role in financing the economy. The question then is what are the necessary conditions for ***market based financing*** to work? In my opinion, the single most important condition needed is that trust in the system has to be rebuilt. The question then is how do we go about rebuilding trust?

One important pre-condition to rebuilding trust is that the **systems and framework** in which markets operate should be safe and solid. With the crisis having caused a loss of 15% to global GDP, the fallout of the financial crisis has had an increasingly negative impact on human rights which includes the right to development. The burden of both the crisis and the policy responses has fallen disproportionately on those least responsible for the crisis and least able to bear its impacts, especially the most vulnerable and marginalised groups. It is important therefore to make the system safe and reduce systemic risk. Together with the G20 and the Financial Stability Board, IOSCO has been working in this area of making the financial system safer (also called "macroprudential"), and therefore ultimately protecting the investor by preventing a major blow up of the financial system. It is doing this through its work on: OTC derivatives, Financial Markets Infrastructure (including central counterparties or CCPs); shadow banking, having issued recommendations for the regulation of money market funds and securitisation; dark pools and high frequency trading; financial benchmarks; non-bank non-insurance systemically important financial institutions (SIFIs); and credit rating agencies (CRAs), to name a few.

IOSCO is now more pro-active in identifying ***emerging risks***. We have produced our **first Securities Markets Risk Outlook.** It identifies **four main risks** from the point of view of securities markets:

Risks associated with the low interest rate environment and search for yield including a return of investments with structural leverage.

Risks associated with collateral management in a stressed funding environment because bank capital requirements and margin requirements for OTC trades can result in increased demand for high quality collateral. Collateral transformation as well as repo and re-hypothecation, which are transactions executed in the securities markets, can result in risks.

Risks in the OTC derivatives space: A major element of the OTC reform package involves the mandatory clearing of derivative contracts through CCPs. Shifting risk from bilateral OTC contracts to a single point of infrastructure can be a challenging balancing act.

Risks associated with reversal of capital flows to Emerging Markets.

We have also produced a staff working paper on the risks of **cybercrime** on trading venues and are working on the areas of **crowd funding** and **bond market liquidity**.

In addition to rebuilding trust in the safety and soundness of the financial system from a macroprudential point of view, there is another key aspect: that the investor should feel confident that he or she will not be cheated. This calls for increased efforts at investor protection, and that is also core IOSCO work. We have been carrying out this work through issuing principles for disclosure and accounting; regulation of market intermediaries and investment managers. We will be issuing recommendations shortly on the protection of client assets; we have issued recommendations on disclosure at the *point of sale*; and on investor suitability for complex financial products. Taking note of the present trends, IOSCO is working on the impact of social media on financial promotions, including ways market intermediaries are using Facebook, Twitter and LinkedIn to promote products and services.

Another project, again in line with the present trends, is the use of automated or internet based advice to customers and how suitability requirements are to be taken into account in such cases. We also have an investor alerts system that issues frequent alerts based on information received from various jurisdictions. Investor education is of course an important part of investor protection. For this, IOSCO has launched an "*Investor Education Gateway*" on its website, which allows our members to showcase and share their web based investor education work. There are some great examples here. IOSCO has further strengthened its efforts in this area by setting up a new Committee on Retail Investors this year. While we continue to believe strongly in disclosure, we are also looking at areas where disclosure itself might not be enough.

At an IOSCO Regional Committee meeting last week, we discussed how different parts of the world- specifically Europe, Canada and Australia- regulate conflicts of interest. Interestingly, these jurisdictions ask that conflicts should be addressed by: Firstly, **avoiding** conflicts that can have serious potential impact on clients; then **controlling or managing** the effects of the conflict and only finally through **disclosure**. For example, incentives and compensation practices often lead firms to focus on pushing products where they obtain the most revenue. Many of the recent mis-selling scandals have their roots in firms' compensation-related conflicts. For example, the Payment Protection Insurance (PPI) scandal, the most expensive consumer scandal in the UK that may cost banks up to £20bn, and the Storm financial advice scandal in Australia involved financial incentives that led to recommendations for highly leveraged strategies to all clients. These strategies caused significant customer harm.

In terms of the Regulatory responses to such compensation-related conflicts of interest, the UK has banned third party payments to advisors and issued guidance on compensation at the sales person level. In Europe, MiFID only permits third party payments that do not create conflicts. Australia has banned conflicted remuneration: any money or benefit that may distort advice to retail clients. Therefore, a number of jurisdictions are clearly going beyond pure disclosure.

We are also looking at aspects of behavioural economics, a topic on which we had a very interesting Roundtable discussion at the IOSCO Board. Just to give one example of behavioural economics in an experiment carried out by the UK FCA. Letters that were issued to consumers mentioning how they could claim compensation had a very low response rate. When changes were made to the letter by reducing the amount of text; explaining to readers that the claims' process would only take five minutes; or by sending out reminders, the rate of response jumped by over ten per cent. But when the Chief Executive's signature was used instead of the customer service team, it actually reduced response rates, particularly amongst women! So these are important issues that need to be analysed beyond a bare disclosure approach.

While talking about behaviour, another important aspect is the crucial need to change behaviour, ethics and incentives in firms: the importance of corporate governance reform in firms, deterrent sanctions regimes and remuneration discipline. Enforcement and sanctions are an important aspect of IOSCO's work. In this context, the IOSCO MMOU is an important tool and is the pre-eminent global standard for cooperation relating to enforcement matters. We have close to 100 MMoU signatories now, with over 2,000 instances of exchange of information last year. The MMoU is a really significant cross-border instrument with tough entry conditions as even banking secrecy laws are not allowed to be an obstacle. In an increasingly globalised market, the MMoU makes it difficult for perpetrators of securities market violation to escape. I can mention here that the MMOU was also put to good use in the LIBOR scandal investigations.

To sum up:

Market based financing is going to be increasingly important going forward. For this to happen, however, we will need to look at **three important issues**: regaining confidence by **making the system safer**; regaining investors' trust through investor protection measures, proper corporate governance and enforcement; and at the same time allowing markets to function in a globalised environment for the greater good of the citizens. One of the issues here is of cross-border conflicts. In a globalised world, the role of international standard setting bodies like IOSCO is crucial for all these three issues- namely systemic safety, investor protection and allowing markets to function- so that globally harmonised rules can be adopted by jurisdictions, minimising frictional losses and regulatory arbitrage.

Thank you for your attention.