



“Canada’s Role in Expanded IOSCO Principles”

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Thank you, Babak, for your kind welcome.

I also would like to thank the Toronto Centre for inviting me to speak today. Thank you for the opportunity to discuss Canada's role in the IOSCO project on risk management.

Canada's regulatory system

Since this is an international audience and different jurisdictions have different regulatory structures, let me begin by giving you a brief overview of Canada's regulatory system and the role of the Ontario Securities Commission in it.

In Canada, banking is regulated federally and securities are regulated provincially. We have 13 provinces and territories, each responsible for its own securities regulation. However, the provinces and territories work together through an umbrella organization called the Canadian Securities Administrators, or "the

CSA”, to co-ordinate and harmonize rule-making at a national level.

The Ontario Securities Commission regulates the capital markets in Ontario, including oversight of the Toronto Stock Exchange and other trading platforms. Ontario is Canada’s largest province by population. Toronto is Canada’s largest city and ranks tenth globally as a financial centre. The TSX is eighth-largest equity exchange in the world by market capitalization, at \$1.9 trillion.

The Ontario Securities Commission and Quebec’s securities regulator, the Autorité des marchés financiers (AMF) are ordinary members of IOSCO. The Alberta Securities Commission and the British Columbia Securities Commission are associate members.

Systemic risk

Moving to the topic for discussion today, systemic risk, in the wake of the financial crisis of 2007 and following, promoting

financial stability has become a fundamental objective of securities regulators – it is critical for protecting the interests of investors and the integrity of our markets.

While there is no one agreed-upon definition of systemic risk, it is essentially the risk that a problem at a firm, in a market, or at a payment or clearing system becomes widespread and impacts other firms, other markets and, ultimately, the financial system as a whole. It is the risk that arises as a result of the interconnected nature of global financial firms and financial markets.

G20 and FSB commitments

Before the financial crisis, systemic risk was primarily within the purview of prudential regulators, but the role played by securities markets as a vehicle for transmitting risk, before and during that crisis, as well as the growing interconnectedness of the world's capital markets has meant that securities regulators must now assume a key role in maintaining financial stability. As a result,

securities regulatory initiatives with respect to systemic risk have become increasingly international in scope and require collaborative policy responses from both securities and prudential regulators.

The response by securities regulators to systemic risk has been animated by various commitments entered into by the G20 countries and the Financial Stability Board (FSB). The G20 is committed to strengthening the regulation, supervision and infrastructure of the global financial system. This includes mitigating systemic risk to that system, particularly in the area of over-the-counter (OTC) derivatives.

These commitments by G20 ministers have required securities regulators to move beyond the traditional systemic risk focus on issues like clearing and settlement. Securities regulators must now participate in macro-prudential efforts to promote a system-wide approach to financial regulation and to work with central banks

and other financial authorities to develop the tools to address systemic risk. This work requires considerable co-ordination.

IOSCO report on systemic risk

In June 2010, IOSCO responded to these challenges by expanding its principles and objectives of securities regulation to include two new principles, which focus on:

- managing systemic risk, and
- reviewing the perimeter of regulation.

IOSCO then created a Working Group on Systemic Risk to address the role that securities regulators could play in promoting financial stability. The OSC and the AMF co-chaired the Working Group, which published a discussion report in February 2011, called *Mitigating Systemic Risk*. This report serves as the foundation for the work of the IOSCO research unit and new IOSCO Standing Committee on Risk and Research.

Essentially, the paper says that securities regulators need to consider:

- how to incorporate the monitoring and mitigation of systemic risk into their traditional responsibilities for maintaining fair and efficient markets and protecting investors;
- how to learn from monitoring techniques used by central banks and prudential regulators, but to adapt these to their own realities within the capital markets; and
- how to apply the traditional tools of securities regulators to address systemic risk.

The report highlights the importance of disclosure and transparency in identifying systemic risk and arming regulators with the necessary information to address it.

The report also describes business conduct supervision as being “essential to managing conflicts of interest and the build-up of undesirable incentive structures within the financial system.”

Finally it discusses the importance of addressing the risks posed by excessively complex securities products.

Canada’s response to systemic risk

IOSCO and the G20 agree that co-operation is an essential part of the international response to systemic risk. But how is this overall approach contributing to the development of specific reform projects?

While derivatives reform is a priority internationally and domestically, reform in other areas such as market integrity and efficiency, financial market infrastructure and securitization is also critical to mitigating systemic risk.

Let me turn to derivatives reform first and the role played by the OSC in this context.

Derivatives reform – IOSCO initiatives

Derivatives reform is a key priority for the G20 because of the role played by these instruments in the global financial crisis. Canada's response in this area is occurring at a number of different levels, including making significant contributions to global reform, and developing a comprehensive oversight framework domestically for derivatives markets.

For example, the OSC is a co-chair of IOSCO's Task Force on OTC Derivatives Regulation, which is co-ordinating efforts to develop supervisory and oversight structures related to OTC derivatives markets. The OSC led the Task Force's recent work that resulted in the recently published IOSCO Report on Derivatives Market Intermediary Oversight.

In May, the OSC chaired a meeting of senior OTC derivatives regulators from around the world to discuss issues related to the implementation of new international standards for OTC

derivatives, including pre- and post-trade transparency, margin, clearing and access to data.

Derivatives reform – Heads of Agencies

The OSC is also collaborating with central banks, prudential regulators and other securities regulators to deliver on Canada's G20 commitment to regulate OTC derivatives.

At the national level, an inter-agency group called the “Heads of Agencies” is co-ordinating the efforts of prudential and securities regulators to develop a comprehensive regulatory regime for OTC derivatives in Canada. The group brings together the Bank of Canada, federal Finance Department, the Office of the Superintendent of Financial Institutions (OSFI), the OSC, and the Quebec, Alberta and B.C. securities commissions (AMF, ASC, BCSC).

The objective is to develop a robust infrastructure for Canada's OTC derivatives markets and enhance the transparency of those markets. In October 2010, the Heads of Agencies published its interim recommendations, which called for:

- central clearing of OTC derivatives;
- mandatory trade repositories, and
- migrating standardized transactions to electronic trading platforms or exchanges, where appropriate.

Derivatives reform – CSA initiatives

Within the CSA, we are working toward the introduction of a harmonized regulatory framework for OTC derivatives that would allow those markets to continue to develop in a transparent, efficient, accessible and competitive manner (efficiency of price discovery).

In November 2010, the CSA published Consultation Paper 91-401: *Over the Counter Derivatives Regulation in Canada*, which addressed the regulation of OTC derivatives and presented high-level proposals for their regulation in Canada. The CSA has since published consultation papers on:

- Trade repositories and trade reporting
- Surveillance and monitoring
- Segregation and portability in OTC derivatives clearing
- End-user exemptions
- OTC derivatives clearing

At a high level, the CSA's recommendations include:

- mandatory reporting of all derivatives trades by Canadian counterparties to a trade repository;

- mandatory central clearing of OTC derivatives that are determined to be appropriate for clearing; and
- permitted exemptions from OTC regulation for parties using derivatives for hedging purposes.

The CSA is working on the last three of its eight follow-up consultation papers that build on the November 2010 regulatory proposals. These papers will cover registration, trading platforms, and capital and collateral requirements. The CSA is aiming to have a complete framework by the end of 2012 (the G20 deadline).

Ontario

Concurrently, in Ontario, we are in the process of developing Ontario's framework for regulating OTC derivatives. A new piece of provincial legislation, Bill 135, gave the OSC the authority to regulate OTC derivatives. The more detailed rules that we will develop will be co-ordinated with the CSA and Heads of Agencies, while taking into account international developments.

Other areas of reform – IOSCO initiatives

Promoting financial stability is broader than just OTC derivatives.

The OSC is working with other IOSCO members in a number of other areas to develop processes aimed at monitoring risks to financial stability, including:

- **Market integrity and efficiency:** Developing tools to address technological challenges to market surveillance that complement IOSCO's work on electronic trading, dark pools and high frequency trading.
- **Financial market infrastructure:** Updating principles for systemically important financial market infrastructures, such as clearing and settlement and payment systems, and developing appropriate safeguards to support a global approach to clearing.

- **Securitization:** Developing principles for oversight of securitization regimes, including approaches for risk retention, transparency and standardization of securitized products.

However, IOSCO is not the only global regulator active here.

On April 25, Financial Stability Board Chair Mark Carney said the FSB will issue recommendations on regulating the shadow banking sector by November 2012.

Other areas of reform – CSA initiatives

Let me touch on other domestic initiatives that are being undertaken by the OSC and our CSA colleagues that are intended to complement IOSCO's efforts. Three areas in particular that I'd like to mention are:

- credit rating agencies
- securitized products; and
- electronic trading.

Credit rating agencies

The financial crisis showed that improperly assigned credit ratings can create systemic risk, especially when users place heavy reliance on ratings. Unanticipated and abrupt downgrades can lead to a crisis of investor confidence. More generally, the conduct of a credit rating agency's business can significantly impact credit and securities markets.

Since the crisis, the CSA has worked to create an oversight regime for credit rating agencies, which came into effect in January 2012.

Credit rating agencies in Canada are now required to apply to become a "designated rating organization" before their ratings can be used under securities law. A designated rating organization must comply with rules relating to conflicts of interest, governance, conduct, a compliance function and required filings.

The requirements are consistent with international regimes and European Commission endorsement and certification provisions. On April 30, 2012, the CSA granted four entities status as a designated rating organization under the new regulatory framework.

The next policy initiative I would like to discuss is the regulation of securitized products.

Securitized products

The OSC and Alberta Securities Commission are co-chairs of the CSA committee working on securitized products regulation. The CSA published proposals to reform the regulation of securitized products in April 2011. The proposals include enhanced disclosure requirements for securitized products, as well as reforms to how securitized products are issued under prospectus exemptions.

Following commentary on these initiatives, revised proposals are expected to be published later this year.

The last policy initiative I would like to mention involves electronic trading.

Electronic trading

The CSA and the Investment Industry Regulatory Organization of Canada (IIROC), a self-regulatory organization overseen by securities regulators, published a final rule on June 28 that would require dealers and exchanges to take an active role in managing the risks of electronic trading to investors and the maintenance of fair and orderly markets.

National Instrument 23-103 *Electronic Trading and Direct Electronic Access to Marketplaces* mandates dealers to manage risks associated with various methods of electronic trading, including the use of algorithms and high frequency trading. These requirements are consistent with international developments for

managing these risks and maintaining investor confidence in the capital markets.

Monitoring the implementation of systemic risk initiatives

So what's next? With numerous reform initiatives well underway around the world, regulators and other agencies are shifting focus to monitoring the extent to which the new standards are being implemented. The Financial Stability Board recently published a framework for the implementation of G20 reforms and priority areas, including OTC derivatives regulation, which will undergo intensive monitoring and reporting on a country-by-country basis.

In January, the FSB published its findings on its Country Peer Review of Canada's regulatory response since the financial crisis. The FSB noted that "the response of Canadian authorities to the global financial crisis was swift and effective." The report found that the OSC and other Canadian authorities have made good

progress in addressing earlier FSAP recommendations across a variety of areas.

In February, IOSCO approved the establishment of its own Assessment Committee, which consists of members from 30 jurisdictions, including Ontario. The task of the committee is to develop programs to review the extent to which IOSCO members have implemented the Objectives and Principles of Securities Regulation. The review programs will consist of Country Reviews and Thematic Reviews. The first Thematic Review will focus on Principles 6 and 7 – the new IOSCO Principles dealing with systemic risk and perimeter of regulation. All IOSCO members will be invited to participate. We anticipate that these review programs will intensify and more reviews will be carried out by IOSCO and others in the next few years.

Going forward, the focus for securities regulators is to continue to make progress on developing and implementing reform initiatives

that are being led by IOSCO and the FSB relating to oversight and regulation of shadow-banking, OTC derivatives, market infrastructures, methodologies for identifying systemically important non-bank financial entities, reducing reliance on credit rating agencies, and strengthening cooperation and supervisory oversight.

Conclusion

In summary, we believe that we are responding to the challenges presented by the financial crisis. Managing systemic risk has always been considered important, but now it's a heightened priority. Canada is engaged at the international, national and provincial levels in addressing systemic risk. And it's no longer a separate area of focus; it's become part of the DNA of the organization.

What I mean by this is that, at the OSC, we are integrating systemic risk planning into our strategic planning and ongoing

policy work. For example, supporting and promoting financial stability is a new organizational goal for the OSC. This includes establishing a new Emerging Risk Committee to strengthen the OSC's capabilities in risk identification and management. The OSC is also devoting more resources to enhancing its research capabilities, which will benefit its work both domestically and internationally.

In 2009, the CSA established a Systemic Risk Committee, chaired by the Alberta Securities Commission, to develop and implement a process to follow up on and monitor identified systemic risks or related knowledge gaps in the Canadian capital markets. The committee also works to build and share knowledge of systemic risk within the CSA and with other domestic regulators or agencies.

In our view, it is crucial that prudential and securities regulators understand the need to co-operate in responding to systemic risk

issues. As securities regulators, we now think about systemic risk differently and we are acting differently as an organization because promoting financial stability is critical to protecting investors and maintaining fair and efficient capital markets.

The OSC has been pleased to contribute to key IOSCO initiatives on systemic risk and is committed to working with IOSCO on ongoing and future initiatives in this area.

Now that you have had an opportunity to hear from me, I would welcome hearing from you on any of the issues I've touched on today.

Thank you very much for your attention.