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Mr. Greg Tanzer
Secretary General
International Organization of Securities Commissions
C/Oquendo 12
28006 Madrid
Spain

19th June 2009

Dear Mr Tanzer,

Public Comment on Consultation Report on Unregulated Financial Markets and Products

The CFA Institute Centre for Financial Market Integrity ("CFA Institute Centre") welcomes the opportunity to comment on the International Organization of Securities Commissions ("IOSCO") Consultation Report on "Unregulated Financial Markets and Products" (the "Consultation").

The CFA Institute Centre promotes fair, open, and transparent global capital markets, and advocates for investors' protection. We welcome IOSCO's efforts to establish interim recommendations for the advancement of regulatory proposals related to unregulated financial markets and products. These recommendations focus on improving transparency, market integrity, and investor protections, specifically in the markets for securitised products and credit default swaps (CDS). These efforts stem from the G20 aims to review the scope of financial regulation. We appreciate that IOSCO's recommendations for regulatory changes are intended to supplement existing industry initiatives and standards in order to establish a more coherent and consistent regulatory framework.

The Consultation focuses on securitisation and CDS markets because of their systemic significance. In particular, these markets are global, and have become critical to the flow of credit amongst the financial sector and to the real economy. The dysfunction in wholesale credit markets has materially impaired the channel of bank lending. It is therefore expedient to examine the level of oversight in these markets and we welcome efforts aimed at strengthening market functioning and efficiency.

Executive Summary

The Consultation addresses firstly securitisation (which includes, inter alia, asset-backed securities (ABS), asset-backed commercial paper (ABCP), collateralised debt obligations (CDOs) and other variants thereof), and secondly, credit default swaps.

Securitisation

- The issues related to securitisation are grouped into three main categories; namely, (a) wrong incentives, (b) inadequate risk management practices, and (c) regulatory structure and oversight issues.

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- The incentives structure in the market for securitised products was flawed, in that it was considered to have encouraged some participants to lower their underwriting standards in order to increase their inventory of securitised products. IOSCO's recommendations to address wrong incentives focus on protecting investors through more thorough disclosures, and through improved business conduct and practices on the part of market participants. IOSCO also recommends that originators/sponsors retain an economic exposure to the securitisation, which would better align the interests of issuers with the interests of investors. The CFA Institute Centre supports these recommendations.

- Inadequate risk management practices arose as a result of poor-quality disclosures and limited information provided to investors concerning the characteristics of securitised products. In many cases, the inability to accurately assess risk resulted in an over-reliance on the ratings of credit rating agencies (CRAs). IOSCO's recommendations to address risk management issues include enhanced transparency and better-quality disclosures to investors to facilitate robust due diligence. IOSCO also recommends strengthening investor suitability requirements, as well as developing alternative means to assess risk with the support of the buy-side. The CFA Institute Centre supports these recommendations.

- Regarding regulatory structure and oversight, IOSCO recommends that jurisdictions assess the scope of their regulatory reach and consider which enhancements to regulatory powers are needed to restore confidence in these markets. IOSCO further comments that regulatory measures should be extended only to the extent necessary to address the deficiencies identified. We broadly agree with these sentiments.

Credit Default Swaps

- The issues identified in relation to the CDS market include counterparty risk, lack of transparency, and operational risk. Industry initiatives have done much to address operational issues (such as greater automation in the clearing and settlement process and portfolio compression initiatives). Regulatory action has therefore focused on counterparty risk and transparency issues.

- The CFA Institute Centre supports regulatory initiatives to facilitate the establishment of central clearing counterparties for relatively standardised CDS contracts. Centralised clearing mitigates counterparty risk, improves post-trade transparency (as the clearer acts as a central repository for the aggregation of data on volume and prices), and can help reduce operational risk by simplifying trade processing and settlement.

- CFA Institute Centre also supports measures to increase transparency in the CDS market. An open market structure enables more efficient price formation, reduces informational asymmetries, and enhances overall investor confidence.

- Price transparency can be further improved through greater use of more standardised contracts, where feasible. However, we caution that there should also be ample scope for the existence of bespoke contracts, so that counterparties can continue to hedge their risks in a manner that is tailored to their specific needs. A more practical

solution that will aid transparency is to push for such markets to move to electronic platforms. These platforms would not require standardisation, per se, but would provide greater transparency to regulators and investors, alike.

We attach our response that addresses the recommendations of the Consultation. Please do not hesitate to contact us should you wish to discuss any of the points raised.

Yours faithfully,

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The CFA Institute Centre is part of CFA Institute[1]. With headquarters in Charlottesville, VA, and regional offices in New York, Hong Kong, London, and Brussels, CFA Institute is a global, not-for-profit professional association of more than 94,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 131 countries, of whom nearly 83,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

The CFA Institute Centre develops, promulgates, and maintains the highest ethical standards for the investment community, including the CFA Institute Code of Ethics and Standards of Professional Conduct, Global Investment Performance Standards ("GIPS®"), and the Asset Manager Code of Professional Conduct ("AMC"). It represents the views of investment professionals and investors before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and the transparency and integrity of global financial markets.

Our detailed comments follow the order of the Consultation's recommendations.

Specific Comments

1. Securitisation

a) Technical Committee recommendations that address wrong incentives

TC interim recommendation #1:

IOSCO encourages industry responses in the securitisation market and recommends the following regulatory responses:

1. *Consider requiring originators and/or sponsors to retain a long-term economic exposure to the securitisation;*
2. *Enhance transparency through disclosure by issuers of all checks, assessments and duties that have been performed or risk practices that have been undertaken by the underwriter, sponsor, and/or originator;*
3. *Require independence of experts used by issuers; and*
4. *Require experts to revisit and maintain reports over the life of the product.*

As the Consultation notes, the financial incentives structure in the market for securitised products was flawed, in that it was considered to have encouraged some participants to lower their underwriting standards in order to increase their inventory of securitised products. The 'wrong incentives' may therefore be considered a by-product of the originate-to-distribute securitisation model.

[1] CFA Institute is best known for developing and administrating the Chartered Financial Analyst curriculum and examinations and issuing the CFA Charter.

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The CFA Institute Centre is fully supportive of the Technical Committee's (TC's) recommendations set out above. These are aimed at protecting investors through more thorough disclosures, and through improved business conduct and practices on the part of market participants.

With regards to point (1), requiring originators and/or sponsors to retain an economic exposure to a given securitisation helps ensure an alignment of interests between those structuring the issue and those investing in the issue. This is the so-called "skin-in-the-game" requirement. A recent example of this requirement being introduced into legislation is the EU's Capital Requirements Directive, whereby it is proposed that originators/sponsors retain a 5% economic exposure to a securitisation (for example, a holding of 5% of the nominal value of the securitisation). Whilst we do not comment on the appropriateness of a particular threshold, we support the principle that issuers retain a portion of the securitisation on their books. This bolsters investor confidence in the issue under consideration and thus improves market functioning. However, it should be noted that securitisation retention requirements should not be viewed as a substitute for (or as a dilution of the need for) investor due diligence.

We fully support the transparency recommendations in point (2), namely that issuers disclose all checks, assessments, risk practices and duties that have been undertaken in the process of structuring the issue. Such disclosures should facilitate more thorough due diligence on the part of investors, and improve investor understanding of (and decision-making in relation to) the products. These transparency measures complement the retention requirement in point (1) and contribute to enhancing market integrity. However, the Centre believes that this information should supplement other more relevant data about the characteristics and demographics of the underlying loans, such as weighted-average loan-to-value ratios; percentage of loans underwritten using no-, low-, or full-documentation; geographical concentrations; and weighted-average interest rates, at a minimum.

The CFA Institute Centre supports the use of independent experts by issuers when performing valuations, analysis, or making other assessments related to the underlying asset pool and the risk characteristics of the securitisation. Independent assessments minimise the scope for fraud and/or impropriety, and hence strengthen investor confidence in the issue. It is also important that this requirement encompasses those analysts assigning credit ratings to the securitisation, who should be independent of those persons who engage in fee negotiations with the issuer, and who should not have any material economic interest in the issuer.

We also agree that such experts should revisit and maintain reports over the life of the product, in order to ensure that investors are provided with the most up-to-date information on which to base their decision-making processes.

b) Technical Committee recommendations that address inadequate risk management practices

TC interim recommendation #2: *IOSCO encourages industry responses in the securitisation market and recommends the following regulatory responses:*

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1. *Mandate improvements in disclosure by issuers including initial and ongoing information about underlying asset pool performance and the review practices of underwriters, sponsors and/or originators including all checks, assessments and duties that have been performed or risk practices that have been undertaken. Disclosure should also include details of the creditworthiness of the person(s) with direct or indirect liability to the issuer.*

2. *Strengthen investor suitability requirements as well as the definition of sophisticated investor in this market.*

3. *Encourage the development of alternative means to evaluate risk with the support of the 'buy-side'.*

The Consultation notes that inadequate risk management practices arose as a result of poor-quality disclosures and limited information provided to investors concerning the characteristics of securitised products. Consequently, investors may have lacked sufficient means to accurately assess, model, and price risk. Put in another context, the output of risk models could only be as good as the quality of the information inputted. In many cases, the inability to accurately assess risk resulted in an over-reliance on the ratings of credit rating agencies (CRAs).

The CFA Institute Centre supports the TC recommendations. More transparency and better quality disclosures to investors facilitate more robust due diligence. Ongoing disclosures enable investors to conduct monitoring of the structure and the underlying asset pool over the life of the product. We also support industry initiatives (noted in paragraph 63 of the Consultation) to establish, inter alia, standardised definitions, calculation methodologies, and key product data for securitised products, and to establish market standards of due diligence disclosure and quality assurance practices.

Investor suitability requirements would impose an obligation on distributors to ensure that the securitised product meets the requirements of investors with respect to their risk and return needs. It would also be necessary to establish a clear and consistent definition of a 'sophisticated investor' when formulating suitability requirements.

We fully support these recommendations, which are key to ensuring investor protection. Firms that sell these instruments to investors have a duty to ensure that the products are in the best interests of investors. However, product suitability is a widespread problem, which often extends beyond the securitisation market. For example, a recent poll conducted by CFA Institute in collaboration with the European Commission showed that almost three quarters (73%) of respondents based in the European Union believe fee structures of investment products drive their sales to customers rather than their actual suitability[2].

Accordingly, efforts to strengthen investor suitability requirements are welcome, and we urge regulatory authorities to adopt a horizontal approach across product classes.

[2] The full results can be viewed at http://www.cfainstitute.org/aboutus/press/release/09releases/20090421_01.html

Finally, with regard to point (3), we recognise that risk measurement and evaluation techniques need to be improved. 'Buy-side' professionals have a fiduciary duty to their clients (end investors) to ensure that their investment decisions embed a degree of risk that is commensurate with investors' needs and preferences (their ability and willingness to take risk). Involving the buy-side in the development of alternative methods to evaluate risk should ensure a better alignment of interests between the risk management process and investors' needs.

c) Technical Committee recommendations that address regulatory structure and oversight issues

TC interim recommendation #3:

IOSCO recommends that jurisdictions should assess the scope of their regulatory reach and consider which enhancements to regulatory powers to support TC interim recommendation #1 and #2 in a manner promoting international coordination of regulation are needed.

The Consultation notes that (para. 76-77): *"The challenge for regulators is to help create conditions under which information rich business is encouraged to resume, consistent with investor protection and to encourage globally coordinated solutions… Each jurisdiction will need to assess the scope of existing regulatory parameters and expand that scope only to the extent necessary to take measures identified to restore confidence in the securitisation market."*

We broadly support these sentiments and have no further comments.

2. Credit Default Swaps

a) Initiatives that address counterparty risk, lack of transparency, and operational risk

TC interim recommendation #4

IOSCO encourages industry responses in the CDS market and recommends the following regulatory responses:

1. *Provide sufficient regulatory structure for the establishment of CCPs to clear standardised CDS, including requirements to ensure:*
   a) *Appropriate financial resources and risk management practices to minimise risk of CCP failure;*
   b) *CCPs make available transaction and market information that would inform the market and regulators; and*
   c) *Cooperation with regulators.*

2. *Encourage financial institutions and market participants to work on standardising CDS contracts to facilitate CCP clearing.*

3. *CPSS [Committee on Payment and Settlement Systems]-IOSCO Recommendations for CCPs should take into account issues arising from the central clearing of CDS.*

4. *Facilitate appropriate and timely disclosure of CDS data relating to price, volume and open-interest by market participants, electronic trading platforms, data providers and data warehouses;*

5. *Establish an appropriate framework to facilitate information sharing and regulatory cooperation between IOSCO members and other supervisory bodies in relation to CDS market information and regulation; and*

6. *Encourage market participants' engagement in industry initiatives for operational efficiencies.*

The issues identified in the Consultation in relation to the CDS market include counterparty risk (the risk that a financial counterparty fails to honour its obligations), lack of transparency (trades are conducted over-the-counter, with limited pre and post trade reporting), and operational risk (the large number of contracts and the previous lack of automation and central clearing have posed back-office challenges). Combined with the inter-connectedness of dealers (primarily large financial institutions such as banks and insurers), these factors are considered to have presented a systemic risk to market stability.

Operational risk has arisen from the volume of contracts traded, coupled with the hitherto lack of adequate post-trade infrastructure to handle the settlement process in an efficient manner. As the Consultation notes, this has resulted in backlogs of unconfirmed or unprocessed trades. Over the past year, however, industry initiatives have done much to address operational issues. For example, advancements in technology have facilitated more automated novation, and portfolio compression initiatives (netting contracts and 'tear-ups' for equal and opposite positions) have simplified back-office processes. Further industry initiatives have established protocols for cash settlement, auction-based mechanisms for physical settlement, and most recently, "Big-Bang" changes to CDS contract conventions. These efforts have further simplified and improved the market infrastructure.

Given the initial success of these industry initiatives, regulatory action has focused on counterparty risk and transparency issues.

Most notably, regulatory initiatives have focused on encouraging the creation of central clearing counterparties (CCPs) for relatively standardised CDS contracts such as index contracts and contracts on single-name reference entities with standardised terms. For example, in the United States, ICE Trust has received regulatory approval and has begun operating as a CCP. Similar initiatives are under way in Europe: LCH.Clearnet has established limited central clearing of certain CDS contracts in London, whilst the European Commission continues to work with the industry to establish a European CCP for CDS.

Centralised clearing mitigates counterparty risk as the CCP stands between dealers so that all trades are novated directly to it. In this fashion, individual counterparty creditworthiness is substituted for the collective creditworthiness of the CCP, supported by the posting of initial and variation margin by participants. Centralised clearing can also improve post-trade transparency as the CCP acts as a central repository for the

aggregation of data on volume and prices. In addition, CCPs help reduce operational risk by simplifying trade processing and settlement.

Accordingly, CFA Institute Centre supports regulatory initiatives to facilitate the establishment of CCPs.

CFA Institute Centre also supports measures to increase transparency in the CDS market. An open market structure enables more efficient price formation, reduces informational asymmetries, and enhances overall investor confidence. Combined, these factors facilitate better trading conditions for market participants. As the Consultation notes (para. 93), regulators have been concerned that the lack of transparency may enable some participants to manipulate the market for a given 'reference entity', creating the perception of heightened credit risk. A simultaneous short position in the entity's shares might enable a market participant to profit from the subsequent share price decline. This scenario further underlines the importance of, and need for, greater transparency in CDS markets.

Industry initiatives to date have helped improve market transparency. For example, the Depository Trust & Clearing Corporation's Trade Information Warehouse publishes weekly aggregate data on notional values and number of contracts outstanding.

Price transparency can be further improved through greater use of more standardised contracts, where feasible. However, we caution that there should also be ample scope for the existence of bespoke contracts, so that counterparties can continue to hedge their risks in a manner that is tailored to their specific needs.

A more practical solution that will aid the transparency of the market is to push for such markets to move to electronic platforms. These platforms would not require standardisation, per se, but would provide greater transparency to regulators and investors, alike.

We also support the measures in points (5) and (6) aimed at increasing information sharing, regulatory cooperation, and industry engagement.

b) Regulatory structure and oversight issues

TC interim recommendation #5:

IOSCO recommends that jurisdictions should assess the scope of their regulatory reach and consider which enhancements to regulatory powers are needed to support TC interim recommendation #4 in a manner promoting international coordination of regulation.

The Consultation notes that (para. 108-109): *"The challenge for regulators is to create conditions under which information-rich business is encouraged to continue and to promote international cooperation as necessary... Each jurisdiction will need to assess the scope of existing regulatory parameters and expand that scope only to the extent necessary to take measures identified to reduce risk in the CDS market."*

We broadly support these sentiments and have no further comments.

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3. Developing general recommendations to apply more widely to unregulated financial markets and products

The Consultation notes that (para.114): *"The TC will give consideration to whether some general recommendations about adjustments to the perimeters of regulation relating to standardised and non-standardised OTC derivative products may be drawn from the study of CDS contained in this Consultation Report and public comments".* The Consultation does not establish any interim recommendations at this stage.

We recommend that regulatory authorities carefully consider the nuances of the various OTC markets before making general recommendations applicable to all product classes. For example, as acknowledged in the Consultation, post-trade infrastructure in some markets, such as interest rate swaps, is already well established. Therefore, authorities should take care in ensuring that any further initiatives yield real benefits and do not impose unnecessary burdens on these markets.

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