Topic 1: Financial Market Infrastructures

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Interactive discussion: Question 1 – Howard Wetston

Question 1

From a policy and regulatory perspective, what are the key issues and concerns surrounding exchange mergers? What are the policy and regulatory implications of exchange mergers? Do regulators have the right tools to regulate new, larger and more integrated structures?

(3-4 minutes)

Focus of speaking notes:

- **Transactions are complex and require extensive review by regulatory authorities.**
- **Analyzing the transaction requires examination of the "public interest" which is guided by statutory mandates.**
- **Analysis and regulatory review is tied to market structure and particulars of the transaction.**
- **Regulators must ensure have appropriate and complete tool kit to regulate the resulting structure to ensure quality markets.**

SPEAKING NOTES

Robust regulatory oversight of exchanges is an important responsibility. It is reflected internationally by IOSCO in its Principles of Securities Regulation and in CPSS-IOSCO's recently published *Principles for Financial Market Infrastructures*.

Within this context, there have been numerous announcements of proposed transactions involving infrastructure mergers and acquisitions. Each are different.

- Exchange/clearing agency combinations which results in a vertical model – this is what we are facing in Canada.
- Large exchange groups proposing to merge with other large exchange groups,

which may or may not be vertically integrated.

- Consolidation of exchanges and ATSs – which results in less choice for trading and possible impacts on competition and fragmentation.

In Canada, what we are facing is a purchase of the stock exchange by major capital market players – predominantly banks and pension funds. The intention is to purchase the exchange's biggest competitor and the national clearing agency and depository for the cash market. The result would be a vertically integrated organization that owns the senior stock exchange, the junior stock exchange, and the clearing agencies for equities, fixed income and derivatives.

The proposals differ across jurisdictions, but what they have in common is that they all involve significant market infrastructure entities and the potential changes raise fundamental and complex issues.

The proposals require analysis of what is appropriate in a particular jurisdiction based on the structure of that jurisdiction and the type of players in its market. All are subject to review by the securities regulators and in some cases, by the anti-trust authorities.

The anti-trust authorities have a very different mandate from the securities regulators. I know this from first hand experience. These authorities have a different role in these transactions – looking at tests relating to a substantial lessening of competition, among other considerations.

Securities regulators have a different mandate and role. We are not blocking transactions. We are considering the transactions and assessing the implications to our capital market and the necessary regulatory response to determine whether the resulting structure and operations of the entity is in, or depending on the jurisdiction, not contrary to, the public interest.

The public interest is admittedly a vague standard. It depends on the role of the securities regulator - which is defined by the legislation that guides our work.

In Ontario, our statutory mandate captures:
- Protection of investors
- Fair and efficient capital markets
- Confidence in those markets
- And implicitly, reduction of systemic risk.

To determine if the transaction is in the public interest, the transaction needs to be examined in the context of the market structure in the particular jurisdiction.

For example, the approach to the analysis and the need for and extent of the regulatory framework is very much tied to the structure of the particular market:

- Whether there is competition between marketplaces or clearing agencies.

- Whether there is a vertically integrated or horizontally integrated model.

Some key criteria that should also be considered include:

- Governance – which includes appropriate representation of stakeholders and the management of conflicts of interest

- Fair access

- Fees

- Risk management – which is relevant for clearing agencies

There are other important issues that need to be evaluated. They include:

- The concentration of ownership in the market

- The impact of moving the market to a vertically integrated model, and

- If the transaction is across borders, the regulatory authority that is maintained by the local jurisdiction.

In the context of the transactions involving market infrastructure entities – part of determining if the transaction is in the public interest is determining if the regulators have the tools to manage or address the issues that I have raised – fair access, conflicts, fees, etc.

In addition, consideration needs to be given as to whether the regulator maintains its oversight ability and authority over the resultant entity.

Each regulator must look at its own tool-kit and determine if it can appropriately regulate these entities. As I said before, what this looks like very much depends on the market and its structure.

At the OSC – we think we have those tools – the authority, the resources, the competence and the knowledge of the market. All of these are critical, and we are taking steps to enshrine these tools through our strategic plan.

What we are learning through our process is that these structures need to be subject to enhanced oversight – increased reporting, increased communication and discussion, more terms and conditions relating to integration, outsourcing, fees and incentives and where a monopoly is becoming a for-profit entity, fee regulation.

It is critical to get this right and ensure that whatever authorization or recognition or

licensing is granted, it is flexible to enable the regime to change as circumstances evolve.