

**Task Force on
Unregulated Financial Markets
and Products**

Implementation Report



IOSCO

**TECHNICAL COMMITTEE
OF THE
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS**

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Chapter 1 Executive Summary

Background

The IOSCO Technical Committee Task Force on Unregulated Financial Markets and Products (TFUMP) was formed in November 2008 in support of G-20 calls for a review of the scope of financial markets and in particular unregulated financial markets and products.

In September 2009, following consultation, the IOSCO Technical Committee (TC) released a Final Report, *Unregulated Financial Markets and Products* (Final Report)¹, which examined ways to introduce greater transparency and oversight in unregulated financial markets and products, and improve investor confidence in, and the quality of, these markets.

The Final Report made recommendations about regulatory approaches to be considered by financial market regulators and then implemented as appropriate with respect to securitisation and credit default swap markets. It also discussed the broader unregulated financial markets. The key recommendations that were made in the Final Report concerning securitisation deal with:

- 1) disclosure;
- 2) retention of economic interest (skin in the game);
- 3) investor suitability; and
- 4) international coordination and regulatory cooperation.

At the TC meeting in January 2010, a mandate was approved for TFUMP to monitor the implementation of the recommendations made in the Final Report that relate to securitisation.

Survey

A survey was circulated to TFUMP members in February 2010 to determine the level of implementation of the recommendations made in the Final Report that relate to securitisation. Responses reveal that all jurisdictions surveyed had at least one, if not multiple initiatives in progress to implement the recommendations. Most measures are expected to be implemented in 2010 and 2011.

Themes from the survey are as follows:

- The skin in the game concept is endorsed by most jurisdictions at this time. Furthermore, the majority of member jurisdictions are expected to implement the requirement for originator/sponsors to retain long term economic exposure to the securitisation;²

¹ *Unregulated Financial Markets and Products*, Final Report, Report of the Technical Committee of IOSCO, September 2009, available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD301.pdf>.

² Canada, Hong Kong and Japan are still considering the appropriateness of implementing this concept.

- In many instances, current laws, regulations or market practices for offering documents often covered elements of disclosure and third party service providers. Most jurisdictions are either enhancing or considering enhancements for these areas;
- In relation to investor suitability, most jurisdictions are refining the definition of a *sophisticated* or *wholesale* investor. Depending on the jurisdiction, a greater burden will be put on the issuer/seller (to determine investor suitability) or on the investor (responsibility to buy products they understand); and
- Industry bodies such as the Association for Financial Markets in Europe, Japan Securities Dealers Association, Associação Brasileira das Entidades dos Mercados Financeiro e de Capitais, Association of German Banks and Australian Securitisation Forum are working with regulators on various TFUMP-related initiatives.

Recommendations

Based on the survey responses and subsequent discussions, TFUMP makes two further recommendations:

- TFUMP Recommendation 1 – IOSCO recommends regulators encourage improvements in disclosure standards for private or wholesale offerings of securitised products; and
- TFUMP Recommendation 2 – IOSCO recommends regulators engage in international cooperation toward convergence of national regulations, where desirable, and review progress regularly.

Chapter 2 Implementation Survey

Methodology

On 9 February 2010, the TFUMP co-chairs sent a questionnaire to all TFUMP member jurisdictions³ in order to ascertain how the seven recommendations relating to securitisation made in the Final Report are being implemented. The seven recommendations are as follows:

- 1.1. Consider requiring originators and/or sponsors to retain a long-term economic exposure to the securitisation in order to appropriately align interests in the securitisation value chain;⁴
- 1.2. Require⁵ enhanced transparency through disclosure by issuers to investors of all verification and risk assurance practices that have been performed or undertaken by the underwriter, sponsor, and/or originator;
- 1.3. Require independence of service providers⁶ engaged by, or on behalf of, an issuer, where an opinion or service provided by a service provider may influence an investor's decision to acquire a securitised product;
- 1.4. Require service providers⁷ to issuers to maintain the currency of reports, where appropriate, over the life of the securitised product;
- 2.1. Provide regulatory support for improvements in disclosure by issuers to investors including initial and ongoing information about underlying asset pool performance. Disclosure should also include details of the creditworthiness of the person(s) with direct or indirect liability to the issuer;⁸

³ TFUMP members are: the Australian Securities and Investments Commission (Australia), Comissão de Valores Mobiliários (Brazil), Autorité des marchés financiers (France), Bundesanstalt für Finanzdienstleistungsaufsicht (Germany), Securities and Futures Commission (Hong Kong), Commissione Nazionale per le Società e la Borsa (Italy), Financial Services Agency (Japan), Comisión Nacional Bancaria y de Valores (Mexico), Authority for the Financial Markets (The Netherlands), Autorité des marchés financiers (Quebec), Comisión Nacional del Mercado de Valores (Spain), Financial Services Authority (United Kingdom), Securities and Exchange Commission (United States of America) and Commodity Futures Trading Commission (United States of America).

⁴ The economic exposure may be to the securities or some other risk exposure to the long-term viability of the securitised product. This has been described in the market as the “skin-in-the-game” requirement.

⁵ A number of different regulatory responses could be taken to enhance transparency, depending on the particular characteristics of the jurisdiction of the regulator. Such measures could include recommending compliance with industry codes of best practice, issuing regulatory guidance or amending legislation and regulation.

⁶ See paragraphs 69-71 of the Final Report for the scope of the term *service providers*.

⁷ Ibid note 6.

⁸ Credit worthiness includes the ability of the person to meet their obligations in respect of representations and warranties made.

- 2.2. Review investor suitability requirements as well as the definition of sophisticated investor in the relevant market and strengthen these requirements, as appropriate, in the context of the relevant market; and
- 2.3. Encourage the development of tools by investors to assist in understanding complex financial products.

With respect to each recommendation, each member jurisdiction was asked to explain:

- The regulatory framework as at 1 January 2008;
- Proposed or actual changes to the regulatory regime since 1 January 2008. If proposed changes are not yet certain, then changes under consideration and possible outcomes; and
- Any Industry initiatives introduced or under development since 1 January 2008 that cover the recommendation.

TFUMP received survey responses from the twelve jurisdictions listed below:

- Australia;
- Brazil;
- Canada;
- France;
- Germany;
- Hong Kong;
- Japan;
- Mexico;
- Netherlands;
- Spain;
- United Kingdom; and
- United States.

Overview

Jurisdictions	Implementing Recommendations						
	1.1	1.2	1.3	1.4	2.1	2.2	2.3
Australia	✓	✓	✓	✓	✓	✓	✓
Brazil	✓	✓	✓	✓	✓	✓	✓
Canada	✓	✓	✓	✓	✓	✓	✓
France	✓	✓	✓	✓	✓	✓	✓
Germany	✓	✓	✓	✓	✓	✓	✓
Hong Kong	✓	✓	✓	✓	✓	✓	✓
Japan	✓	✓	✓	✓	✓	✓	✓
Mexico	×	✓	✓	✓	✓	✓	✓
Netherlands	✓	✓	✓	✓	✓	✓	✓
Spain	✓	✓	✓	✓	✓	✓	✓
United Kingdom	✓	✓	✓	✓	✓	✓	✓
United States	✓	✓	✓	✓	✓	✓	✓

✓ = implemented, implementing or considering implementing the recommendation / recommendation not appropriate for the market
 × = no plans to implement the recommendation

TC Recommendation 1.1 – Skin in the Game

The IOSCO recommendation:

- Consider requiring originators and/or sponsors to retain a long-term economic exposure to the securitisation in order to appropriately align interests in the securitisation value chain.⁹

IOSCO also set out three principles. Any retention requirement should, at minimum:

- (a) Be considered by financial market regulators in light of economic and regulatory features of the domestic securitisation market and include appropriate transitional provisions;
- (b) Be risk sensitive and have regard to the underlying quality of the collateral backing a securitisation; and
- (c) Consider the broad function of securitisation and the impact of increased capital charges, accounting de-recognition treatment and legal true sale issues in the relevant jurisdiction.

Skin in the game was not a regulatory or legal requirement in any market prior to 1 January 2008. However, in practice, for the majority of markets, issuers often held some type of first loss or subordinate exposures in their securitisations. This first loss could have been from a

⁹ The economic exposure may be to the securities or some other risk exposure to the long-term viability of the securitised product. This has been described in the market as the “skin-in-the-game” requirement.

variety of sources, including subordinate and first loss tranches, excess spread, over collateralisation or cash reserves. A few markets, for some products, achieved complete risk transfer, but this was not typical.

There is little consensus for the form that skin in the game will take. Broadly, the requirement will be either a set percentage, such as 5%, or a risk-based approach with more retention for riskier assets. Most jurisdictions will implement or are considering implementing a retention requirement.¹⁰

Smaller jurisdictions are keen to see what is implemented in other major financial centres before they enact rules for their home markets. The concern from smaller jurisdictions is that if they are more conservative than what is enacted in larger markets, their institutions will have a competitive disadvantage. Conversely, if smaller jurisdictions enact a less stringent requirement, convergence or mutual recognition may be difficult.

TC Recommendations 1.2 & 2.1 – Disclosure

The IOSCO recommendations:

- Require¹¹ enhanced transparency through disclosure by issuers to investors of all verification and risk assurance practices that have been performed or undertaken by the underwriter, sponsor, and/or originator; and
- Provide regulatory support for improvements in disclosure by issuers to investors including initial and ongoing information about underlying asset pool performance. Disclosure should also include details of the creditworthiness of the person(s) with direct or indirect liability to the issuer.¹²

Disclosure requirements vary considerably by jurisdiction and issuance type (eg public vs private). While current disclosure/prospectus requirements or market practice cover this area, new directives, legislation, or regulations planned for most jurisdictions will improve the existing framework. Most jurisdictions saw their current disclosure and transparency as adequate, but there is a need for improvement. For example, in Q2 2011, the Canadian Securities Administrators will propose new regulations to enhance prospectus and continuous disclosure as well as on-going disclosure.

In most cases, current disclosure called for portfolio level data. In many cases, this will be enhanced to require loan level data for all or some asset types (typically mortgages).

In April 2010, the Technical Committee Standing Committee on Multinational Disclosure and Accounting (TCSC1) published *Disclosure Principles for Public Offerings and Listings*

¹⁰ Canada, Hong Kong and Japan are still considering the appropriateness of implementing this concept.

¹¹ A number of different regulatory responses could be taken to enhance transparency, depending on the particular characteristics of the jurisdiction of the regulator. Such measures could include recommending compliance with industry codes of best practice, issuing regulatory guidance or amending legislation and regulation.

¹² Credit worthiness includes the ability of the person to meet their obligations in respect of representations and warranties made.

of *Asset-Backed Securities*¹³. TCSC1 is now developing principles for on-going disclosure for public offerings and listings of ABS. Later this year, it may also consider further work to examine the distinction between public and private offerings which could lead to the development of disclosure principles for private offerings of ABS.

Industry initiatives are also focused on improving disclosure through standardisation of documentation and greater transparency of granular data. For example, both the American Securitization Forum through Project RESTART and the Australian Securitisation Forum, have developed residential mortgage-backed securities (RMBS) disclosure and reporting standards which require loan level data disclosure. The European Securitisation Forum has also developed RMBS disclosure and reporting standards.

TC Recommendations 1.3 & 1.4 – Independence of Service Providers and Currency of Reports

The IOSCO recommendations:

- Require independence of service providers¹⁴ engaged by, or on behalf of, an issuer, where an opinion or service provided by a service provider may influence an investor's decision to acquire a securitised product; and
- Require service providers¹⁵ to issuers to maintain the currency of reports, where appropriate, over the life of the securitised product.

The definition of *service provider* excludes rating agencies and auditors. For many jurisdictions, there are few or no outside service providers other than these. The interpretation and intention of this section is to capture third party providers such as appraisers/valuers for large loans in commercial mortgage backed securities. Some jurisdictions had existing requirements around third party service providers with most jurisdictions looking at how they might enhance this area.

TC Recommendation 2.2 – Investor Suitability

The IOSCO recommendation:

- Review investor suitability requirements as well as the definition of ‘sophisticated investor’ in the relevant market and strengthen these requirements, as appropriate, in the context of the relevant market.

Most jurisdictions have investor suitability requirements, often where retail investors received some combination of greater disclosure, more protections or restrictions on buying, than wholesale or sophisticated investors. Jurisdictions are exploring different factors to

¹³ *Disclosure Principles for Public Offerings and Listings of Asset-Backed Securities*, Final Report, Report of the Technical Committee of IOSCO, 08 April 2010, available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD318.pdf>.

¹⁴ See paragraphs 69-71 of the Final Report for the scope of the term *service providers*.

¹⁵ See paragraphs 69-71 of the Final Report for the scope of the term *service providers*.

determine the definition of *sophisticated investor* such as knowledge, experience and skill sets in addition to net worth and type of entity. In most jurisdictions, securitisations were typically only issued to investors classified as sophisticated. While most jurisdictions are looking at investor suitability, there are wide variations in what may or may not be done. For example, in April 2011, local governments in Japan will change from being *sophisticated investors* who can opt to become *general investors*, to *general investors* who can opt to become *sophisticated investors*. In Q2 2011, the Canadian Securities Administrators will propose new rules that narrow the class of investors who can buy securitised products on a prospectus-exempt basis.

In May 2010, the Hong Kong Securities and Futures Commission (HK SFC) announced a package of measures to enhance investor protection for retail investors, including conduct requirements for intermediaries relating to the sale of investment products. Specifically, the HK SFC has codified current *know your client* practices to require intermediaries to characterise a client based on his knowledge of derivatives.

Jurisdictions differed on the relative responsibility between the issuer/sponsor, the seller/distributor and the end investors to ensure investors do not end up with inappropriate assets or assets the investor does not understand. In some cases, a greater burden is being put on investors to ensure they have the proper tools, knowledge and understanding to purchase complex products. In other cases, the onus is being put to the financial advisers, sellers or distributors to ensure that the investors they sell to have the capacity, knowledge and experience to understand what they are buying.

As a further note, the Technical Committee Standing Committee on the Regulation of Market Intermediaries (TCSC3) is reviewing investor suitability issues relating to the distribution of complex financial products through intermediaries. It will also review the definition of *sophisticated investor*.

TC Recommendation 2.3 – Development of Investor Tools

The IOSCO recommendation:

- Encourage the development of tools by investors to assist in understanding complex financial products.

In some jurisdictions, a greater onus is being put on investors to better understand what they are buying and to manage the risks associated with the securitised product. To enable them to better understand securitisations, expanded and enhanced disclosure by issuers is instrumental. It would still be up to the investor to maintain appropriate knowledge, skills and experience to comprehensively understand and select securitised products for investment.

In July 2009, IOSCO released a report on *Good Practice in Relation to Investment Managers' Due Diligence When Investing in Structured Finance Instruments*¹⁶.

¹⁶ *Good Practice in Relation to Investment Managers' Due Diligence When Investing in Structured Finance Instruments*, Final Report, Report of the Technical Committee of IOSCO, 29 July 2009 available at <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD300.pdf>.

In some cases, industry has responded by introducing tools to help investors or sponsoring courses, lectures, symposiums to help educate investors. Most investor tools focus on the sophisticated investor as opposed to the retail investor.

Reshaping the securitisation markets

Through its work, TFUMP has identified a number of concerns relating to securitisation. The following table is a snapshot of the concerns identified and the measures (taken or underway) to address them.

Concern identified	Measures to address the identified concern
<p>Alignment of incentives along the securitisation value chain</p>	<p>IOSCO Recommendation to consider a retention requirement.¹⁷</p> <p>IOSCO is reviewing liquidity risk management and liquidity standards for securities firms. The internal control systems of financial firms, including asset managers will be also be reviewed.</p> <p>The Joint Forum is working on understanding differing incentives of the various participants in securitisation markets and the role regulation has played in those incentives. The aim is to analyse the potential impact of current and proposed reforms on the incentives of those participating in securitisation markets before the crisis. This will assist standard-setters and policy-makers to understand and appreciate the potential impact of reform proposals on the securitisation market and accordingly develop a coordinated suite of policy responses.</p>
<p>Initial and ongoing disclosure, including verification and risk assurance practices, underlying asset pool performance and creditworthiness of counterparties to the issuer.</p>	<p>IOSCO Recommendation to provide regulatory support for improvements in disclosure by issuers.¹⁸</p> <p>IOSCO Recommendation to require enhanced transparency through disclosure by issuers to investors of all verification and risk assurance practices.¹⁹</p> <p>On 8 April 2010, IOSCO released <i>Disclosure Principles for Public Offerings and Listings of Asset-Backed Securities</i>.²⁰</p> <p>IOSCO is developing principles for on-going disclosure for public offerings and listings of ABS.</p>

¹⁷ *Unregulated Financial Markets and Products*, Final Report, Report of the Technical Committee of IOSCO, September 2009, available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD301.pdf>.

¹⁸ *Ibid* Note 17.

¹⁹ *Ibid* Note 17.

²⁰ *Ibid* Note 13.

	IOSCO may consider examining the distinction between public and private offerings which could lead to the development of disclosure principles for private offerings of ABS.
Independence of Service Providers and Currency of Reports	IOSCO Recommendation to require independence of service providers. IOSCO Recommendation to require service providers to issuers to maintain the currency of reports, where appropriate. IOSCO has revised its Credit Rating Agency Code of Conduct. The revisions are summarised in the <i>Report on the Subprime Crisis</i> . ²¹
Investor suitability	IOSCO, as part its review of investor suitability requirements regarding the distribution of complex products through intermediaries, is reviewing issues related to the classification of investors.
International regulatory cooperation and harmonisation.	IOSCO recommendation to implement the recommendations in a manner promoting the international coordination of regulation. ²² IOSCO released <i>Principles Regarding Cross-Border Supervisory Cooperation</i> designed to guide IOSCO members in developing cooperative supervisory arrangements amongst themselves, tailored to their own markets and circumstances and their own legal powers and requirements. The report offers suggestions as to how regulators can enhance cross-border cooperation to better supervise the entities they regulate that have expanded their operations across borders. It also suggests that regulators expand the notion of supervisory cooperation to establish mechanisms to consider and evaluate the global market. ²³
Investor Understanding	IOSCO released <i>Good Practices in Relation to Investment Managers' Due Diligence When Investing in Structured Finance Instruments</i> covering the issue of due diligence by investment managers for structured finance products. Its recommendations can form the basis for best practice for investment managers when investing in structured finance products. ²⁴

²¹ *Report on the Subprime Crisis*, Final Report, Report of the Technical Committee of IOSCO, May 2008, available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD273.pdf>.

²² *Ibid* Note 1.

²³ *Principles Regarding Cross-Border Supervisory Cooperation*, Final Report, Report of the Technical Committee of IOSCO, 25 May 2010, available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD322.pdf>.

²⁴ *Ibid* Note 16.

Chapter 3 Conclusion/Recommendations

The survey results and subsequent discussions have highlighted two areas where further guidance by IOSCO is needed.

Disclosure

While jurisdictions are in the process of enhancing disclosure standards (including pre-issuance and post-issuance disclosure), these standards are generally limited to public or listed offerings of securitised products. However, as noted at paragraph 68 of the Final Report,²⁵ the recommendations as to disclosure are intended to set out best practice for issuers in respect of all other types of securitisation offerings (including wholesale offerings and private placements).

Where regulators may not have the regulatory reach to mandate disclosure requirements for wholesale offerings and private placements, regulators can encourage industry bodies to develop industry disclosure standards. Regulators may choose to endorse the industry standards to provide some regulatory backing.

TFUMP Recommendation 1: IOSCO recommends regulators encourage improvements in disclosure standards for private or wholesale offerings of securitised products.

Convergence in national regulations

While the majority of jurisdictions are implementing the IOSCO recommendations as appropriate, there is a concern that securitisation markets may become more fragmented if each jurisdiction's regulatory requirements are substantially different.

The Final Report recommended that regulators implement the recommendations in a manner promoting the international coordination of regulation. This IOSCO recommendation can be complemented by a further recommendation that regulators work together toward convergence of national regulations, where desirable.

Liaison with industry and international organisations such as IOSCO, the Basel Committee on Banking Supervision and the International and Financial Accounting Standards Boards will be critical in working toward convergence in national regulations.

TFUMP Recommendation 2: IOSCO recommends regulators engage in international cooperation toward convergence of national regulations, where desirable, and review progress regularly.

²⁵ See p.19 *Unregulated Financial Markets and Products*, Final Report, Report of the Technical Committee of IOSCO, September 2009, available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD301.pdf>.