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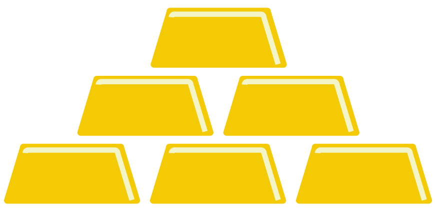

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**As of February 2009 issue, the WFE market figures published in "Focus" newsletter will be limited to main market indicators. The complete version of statistics is available on the WFE website www.world-exchanges.org under "Statistics" as always.*

Contributors of the month

In praise of markets: Why confidence loves transparency - an essay

by Andrea M. Corcoran, Founder and Principal, Align International LLC

In the waning days of 2008, governments and central banks worldwide—with the best of intentions—lurched from one ad hoc intervention to another, multiplying daily the amount of public funds deployed to shore up our faltering financial system. Pundits and academics criticized each approach and forecast the death of investment banking, securitization, community lending, and even in some cases capitalism. Hedge fund managers locked in clients, banks refused to lend, multilateral over-the-counter netting arrangements morphed into bilateral deals. Exiting, discredited, CEOs found that their parachutes refused to open. Pyramid schemes were "outed." The public puzzled over the different bail-out treatment of seemingly similar market players. And, regulators cringed at the wreckage and tried to sweep up the debris.

But through it all, there was one lone ray of light: The performance of our domestic and international exchanges (ie, regulated markets)!

It would be odd, then, if the banking supervisors and the system that brought us to this sorry pass, not to mention the new product, monetary and fiscal policies that supported them, would end up as the primary models for any program to reshape the financial system as some have proposed. It would be especially curious today, when technology can augment the functionality, transparency, operational reliability, and wealth-building capacity of markets in the real and in the financial sector. It would also be strange and disappointing if the result, albeit unintended, were to reduce the competitive strength and network efficiencies of which markets are capable. It is evident that structural reform to restore confidence and to mend global financial system breakage will be squarely on the table in 2009. *Because (if only from a political perspective) the financial sector's commitment to reform will be demanded to address what U.S. President-elect Obama and other world leaders have called "a loss of public trust and accountability," it is important that advocates of capital markets speak out.*

Agenda. This brief essay examines, in an anecdotal way, the purpose of capital markets and why they promote development. It recounts how the markets functioned during the recent, and continuing, credit crisis. It points out how the pillars of regulated market structure (transparency, immediate transaction records, reliability of settlement, rules of trading, and oversight) might be exploited further. It also recommends anticipating any trouble on the horizon to maintain and enhance robust exchange market structures.

Why capital markets? Some aver that securities markets originated in the West. But assuredly markets arose wherever there was trade. The East was also a center of commerce and barter and the idea of passing paper to evidence debt and equity interests in enterprises (though Dutch) and the accounting to explain the system (though Italian) were not unique to the Western World. In essence, capital markets arose to promote the inexpensive raising of capital for enterprises that otherwise would not be funded, or only funded at great cost, by banks. The major innovation of such markets was provision of a mechanism for subscriber/shareholders to monetize their partial interests without selling the enterprise itself. Financial instruments similarly were invented and used from at least the 19th century to avoid usury and other restrictions through the mathematics of put/call parity (the Rothschilds). They were also used, in the case of derivatives, to permit the exit of a seller from continuing liability to an end-user after the seller had assigned its delivery obligation to a middleman; again without moving the property itself. In a word, capital markets were convenience markets for financing. Osaka, as early as the 15th century had a system for trading rice using warehouse receipts, the first asset-backed security.

Much of the innovation (research and development— in a word, progress) in the real sector is underpinned by persons willing to speculate on the profitability of an idea and a marketing plan, coupled with the ability for such persons to convert profits or losses in a timely fashion on their "speculation in/financial support for" a particular enterprise to cash through a system of secondary trading that provides continuous or periodic pricing.. Michael Milken infamously opined that equity markets permit the "democratization of wealth," and he was right on at least that one thing. Markets permit new players to attract capital (Google, RIM, Amazon) where banks servicing an established elite might not. Domestic markets support issuers that at the outset may not be of interest to the international community, and grow new players (Nokia, ICE) or strengthen old ones (Tata). Markets today can attract capital without geographic limit.

Markets also generate information, and information means money. During the past decade, even banks in emerging countries that took large spreads (100's of basis points) for providing loans in private on a relationship basis, increasingly could see the advantages of transparent trading forums, with low transaction costs. Such forums produced information on the direction where prices were going, and on enterprise value, thereby facilitating bank intermediaries' capacity to offer opaque deals upstairs with a precise sense of their likely profitability. Such forums afforded the companion ability to price and disperse risks otherwise difficult to measure and manage. Even banks in traditionally insular economies (Japan) had to stretch their borders to provide financial services to their commercial enterprises that did business in markets on an international basis.

Markets are not burdened with the role of banks and bank supervisors in managing interest rates, exchange rates, payment systems, credit supply and money supply, and strategic goals---all of which are governmental functions related to the stability of the system-- not to the growing of private enterprise. It is very difficult for banks to be efficient allocators of commercial capital without help, and it is even harder to motivate them to do so[1].

So markets, while frequented by banks, brokers and other intermediaries, remain the primary issuer and end-user utilities for liquefying and transferring enterprise interests, for valuing entities, for readily diversifying portfolios, for managing risk, and for adjusting investment allocations. The strength of markets is that they are not banks[2] .

Reliable Operability of Markets under Stress Conditions—Why Markets Should be Part of any Needed Solution. What is remarkable about our present crisis is that even during the worst part of the bank run and credit freeze, the markets, particularly the regulated exchange markets, continued to operate reliably. Some statistics: While investment banks, non-bank banks, and government-sponsored enterprises, were guaranteed, felled or converted to bank holding companies, the price of oil dropped precipitately, the Dow and S & P indexes experienced their largest point drops ever, the largest one week percentage decline, and the largest one-day price rise ever recorded occurred. Nonetheless the markets handled transactions amounting to billions in volume, and showed a profit year-on-year despite a weaker last quarter and a loss of in some cases of as much as 40% of market capitalization[3].

In Europe and the US, markets functioned well as platforms, notwithstanding a series of impulsive measures directed at preventing price overshooting or price bullying through the vehicle of suspension of short selling. Though originally emerging markets seemed immune, eventually the crisis spread there too, recalling the old saw: "when the major markets get a cold, the emerging markets get pneumonia." They also functioned, even so. Moreover, though there was consternation about the price messages being received, a flight to sovereign debt, and renewed vigilance by regulators to prevent manipulations, equity trading velocity increased and new entrants poured into the listed derivatives markets to price their risks and bolster their credit positions by using cleared over-the-counter facilities and volatility trading products. The markets continued to price and to deliver securities and to reflect market sentiment as to the depth and length of

[1] *Some have said that in the US the capital market developed its vibrancy as a possibly unintended consequence of the enforced separation of banking and investment banking under Glass Steagall. Note in this crisis the use of facilities established by the Federal Reserve (the Commercial Paper Funding Facility and the Money Market Funding Facility) to restart the commercial paper market and to provide liquidity to money market funds to facilitate short term credit and money market fund management.*

[2] *It must be noted that in some cases clearing arrangements are banks;* and at one time at least the French Bourse was also a credit institution.

[3] Some markets experienced as much as a 60% loss in market capitalization, reminiscent of the 1997 crisis. **[See chart timeline of crisis.]**

any coming recession, which is what markets are supposed to do. Falling prices permitted issuers both to buy back shares and to strengthen their cash positions.

Also there emerged a preference (as also happened in the crashes of 1987 and 1997) to trade in the more transparent environment (on-exchange) as opposed to the less transparent (upstairs) forums—and an apparent preference for known, gold standard, pricing venues (the LSE) or centralized, relatively transparent liquidity pools as opposed to newer MTS, upstarts, or dark pools (Turquoise, Chi-X, BATs Europe, OMX/Nasdaq, Baikal). For example, in September the LSE experienced an unexpected outage and trades did not migrate to new trading venues. Whether due to stickiness, loyalty, lack of the ability to comparison shop to assure best execution, fear of excessive spreads, opaque inequities or latency, this failure to switch platforms was cited by some observers as a vote of confidence in transparency and in the staying power of the incumbent and regulated market leaders. It is an often observed fact in derivatives markets that on-exchange volume increases whenever the over-the-counter dealer cannot fathom whether he is making his "edge". Where there is uncertainty as to one's counterparties' credit position and perhaps even one's own net worth, the credit enhancement and the operating and access rules of regulated markets appear particularly attractive. That so much anonymous, on-exchange, trading in equities and listed derivatives continued during the financial fallout of last year suggests confidence that our system of regulated markets will continue to function properly and to price instruments as intended if not necessarily as we would desire.

To me, the resilience of markets during crises also demonstrates that the money always flows to where there is the most money to be made. If one cannot reliably predict or measure the actual value of a trade from available evidence, one cannot assure profitable arbitrage. In such a case, one prefers to trade in the market rather than outside it. Informational asymmetries benefit the holder of the greater, not the lesser amount of information, and will discourage transactions by experienced participants if they believe the asymmetries do not favor them. *Hence, the relationship of transparency to maintaining confidence, particularly in times of crisis is not surprising.*

So markets fared well operationally.

Some Issues to Assess in the Coming Debate. But lest we be complacent, the crisis has reinforced some simple verities, and the health of markets could deteriorate as the flight to quality diminishes interest in the potential equity risk premium. The *first* of these is that although there may be as many as 45,000 issues world-wide and only a small portion are cross-listed and internationally-traded, the markets are interlinked, and their participants are intertwined by ownership, customers, products, credit exposures, and information[4] . The *second* is that there is immense public and industry reliance on the operational integrity and equitable access to the prices made in transparent markets and the systems—matching, clearing, settlement attached to these. The *third* is that technology has the capacity to change the dynamics of trading, and credit restriction has the capacity to adversely affect transactions in the market, clearing intermediaries, and the settlement process as well as the framework that assures the continuation of trading platforms. So markets and banks and other market participants are linked inextricably within the system. The *fourth* is that some of the volume of markets has been generated largely through the growth of unregulated entities such as hedge funds. The *fifth* is that notwithstanding their many virtues, securities markets are susceptible to misconduct, fraud, and misuse of other people's money. And *sixth*, fraud and market abuse are killers of market confidence. The *last* is that not every financial product is subject to similar customer protections, even though in many jurisdictions banks, not investment firms, are primary distributors of financial products. Today, therefore there may be significant confusion as to the level of regulation applicable to different markets and marketers.

So what to do, during this period of perhaps involuntary *reflection on the structure of the system in general? How can we best preserve the benefits and mitigate the risks of the markets now and for the future?*

Plumb the Benefits. Now is a great time to re-examine what market mechanisms—rules, rule

[4] *Note that the differential treatment of Lehman client funds held in different jurisdictions for administration has provoked debate. Such treatment occurreddespite apparent legislation consistent with best practices to prevent contagion from such a default, and legal assurances as to the treatment of certain funds held in trust. The freezing of funds in administration has led some to query the robustness of existing systems to prevent cascading defaults and a call for reinforcing a market-based insolvency regime at the international level .*

enforcement, regulatory oversight, and pre- and post-trade transparency— can do. They can:

- find an equilibrium price for illiquid securities;
- develop a product that permits collective investments to have a traded price (ETF);
- offer a platform for hybrid (composite) or venture products that are subject to specified listing standards, and train their issuers to move up to the main list;
- offer reliable credit enhancement through central counterparties;
- integrate exposure management across intermediaries,
- provide instantaneous confirmation and verification of trades and an independent record or audit trail of transactions;
- provide rules for unwinding positions in the event of a systemic problem or error;
- provide facilities for the location of hard-to-locate securities;
- provide arbitration of disputes;
- disseminate breaking news;
- provide different types of structures and auctions for different types of products;
- create affirmative obligations on market professionals to make firm quotes or continuous markets; and
- bind customers as well as intermediaries to the rules of trading.

The current events should provide an impetus for business (as well as regulatory) solutions to address the value of platforms that are subject to oversight and specific rules[5] . For example, more could be done to:

- answer how best to handle hard to price interests (periodic call auctions, ad hoc auctions with reserve pricing);
- means to measure best execution (more and more accessible cross-market data, such as a means of integrating the tape for all equities of same type and issuer);
- adaptation of the market front end (liquidity providers, verification) and back end (clearing, settlement, accounting) to service contracts initiated over the counter;
- better information disclosure to customers on structured products offered on or off exchanges, irrespective of the product vendor, and
- better and more information more generally, such as improved data across several market venues on depth and distribution within any given market venue and about cross-market exposures[6] .

In newer jurisdictions, markets may even provide the means for delivering corporate rights, such as dividends and maintaining direct accounts for participants (Egypt).

As with every crisis, there is an opportunity now to provide business solutions to some of the problems observed—to use and expand the benefits of market structures.

Assess Potential Risks to Confidence. At the same time we should not shrink from acknowledging (as have some recent commentators) that confidence is critical to properly functioning markets, and that market failures are the death knell of confidence and that fear of market failure could become a self-fulfilling prophecy. Many in the over- the-counter markets wrung their hands as the subprime crisis developed—as business men adopted the "everyone is doing it" mentality. The fact that (1) banks cannot withstand a run on uninsured deposits, (2) that raters' ratings for structured products were subject to potential conflicts and rating adjustments unwelcome and untimely, and that (3) credit was mispriced were not only not a secret, but also t were whispered about openly and widely within the financial community. Indeed, some of these issues were the subject of a keynote address on the Perfect Storm, delivered by Lloyd Blankfein, to an IOSCO joint regulatory and industry forum held in London in the October 2006. But, with the possible exception of some ultimately, insufficient additional discipline on the credit default confirmation process, nothing at the public level was done until the system began spiraling out of control.

The problem, now, is how to avoid this type of failure generally and especially how to avoid problems arising in the markets which have functioned well to date. How do we achieve the right incentives, market integrity, accountability and contain inappropriate risk taking while acknowledging that risk taking is essential to market development? How do we assure that the transparent price is in fact the fair and equitable

[5] *In fact the race to offer CDS clearing, and the competition among suggested structures, suggests that most financial services participants recognize the value of a central clearing facility if the right risk management formulas can be found.*

[6] *Reference might be made to work done in the derivatives area internationally, such as the extension of the Tokyo Communiqué to Financial Derivatives, IOSCO document 3 (September 1998); and Information Sharing Guidance, IOSCO Document 2 (March, 1998) at public documents www.iosco.org.*

price? *Perhaps, more fundamentally, how do we define what a capital market should and should not do?*

The exchanges and the international financial community, including regulators, can be ahead of the curve on this. The point is not to rest on any current laurels, but to examine with particularity where future risks to market integrity might lurk. For example, further consideration could be given to:

- governance of markets and their oversight;
- impact of any fragmentation on customer protection and fair prices;
- potential public misunderstanding of which venues are regulated and which are not;
- the appropriate approach and oversight of short selling;
- how to correctly describe what is meant by transparency, especially if different for different platforms;
- how to educate the public on the difference between volume and liquidity ;
- what should be the criteria for admission to trading;
- whether prospectus disclosure is meaningful;
- are there potential lacunae in security systems intended to prevent improper or excessive exposures and to assure that market algorithms are followed;
- do the controls on leverage remain sufficient;
- what are the costs and benefits of risk-based insurance; and
- how more consistency and certainty as to the efficacy of bankruptcy regimes to contain contagion in an international downturn can be achieved.

Further, while markets operated successfully throughout the end-of-year crisis, the markets have not been flawless—there have been issues, here and there, with market prices in takeover situations, voting rights, allegations of insider trading, and other anomalies, especially in products related to interest rates, which were directly affected by government interventions.

In sum, however, the story of markets is a good one. This is an opportunity to remind ourselves of their virtues, and to reinforce them. We can review again the elements of fair prices and executions. We can demonstrate from the top down and the bottom up that there is zero tolerance for fraud. We can assure that market platforms are run by informed risk-takers in accordance with pre-specified rules that apply equally to all participants of the same class. Even engaging on these important issues can evidence industry interest in assuring that markets continue to be engines of growth not ruin. Moreover, while some of the current displacement and deleveraging may prefigure a public policy of consolidation of banking or other institutions[7] , we should not let these policies harm what is essential to fair, efficient and transparent markets. In the end, we should keep our eyes on the agreed international objectives of fair and equitable markets and transparent prices--and try to stay above the political fray.

Andrea Corcoran's biography

Andrea M. Corcoran, is the Founder and Principal of Align International LLC, a financial regulatory consultancy. Ms. Corcoran previously chaired the IOSCO Implementation Task Force, which developed an evaluation methodology for testing compliance with the IOSCO Objectives and Principles of Securities Regulation. She also served for many years in senior positions at the US Commodity Futures Trading Commission addressing issues such as specialist bankruptcy regulations and the crisis interventions and policy responses to Barings and Sumitomo. Ms. Corcoran is currently an adjunct

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[7] *In this regard it may be worthwhile to examine some of the measures taken to promote consolidation apart from the multiple five-year Financial Services Action Plans in the EU, intended to support a single market. In Canada, the State many years ago sponsored consolidation of some of the major banks resulting in five major national banks: Royal Bank of Canada, Bank of Montreal, Toronto Dominion Bank, Bank of Nova Scotia, and Canadian Imperial Bank of Commerce (CIBC). Similarly Canadian officialdom initially favored a split of market functions among provinces (securities regulation being the province of provincial regulators) and then spoke openly in favor of merger of the Montreal derivatives and Toronto equity markets and the creation of a venture platform. Nonetheless, while all this urging was going on, at the same time, new multilateral facilities were emerging (Alpha) as well as fully three new exchanges: CNQ, formerly known as the Canadian Trading and Quotation System, Inc., relaunched as CNSX, the Canadian National Stock Exchange; egX, a global securities marketplace designed for the listing and trading of real estate securities and related financial products; and NGX—the Natural Gas Exchange for national gas futures. Additionally ICE was granted an exemption from being a securities exchange. Notably on January 12, the Federal government in Ottawa announced recommendations to centralize the oversight of securities in Canada. In Japan and Australia, a different model was followed. In the emerging markets, typically the government has supported consolidation (see e.g., China and India), and other infrastructure developments, including sometimes demutualization and listing.*