RIA Knowledge Transfer and Capacity Building Program

COMISIA DE SUPRAVEGHERE A ASIGURĂRILOR

Regulatory Impact Assessment*

- Main Findings and Policy Recommendations -

CNVM Regulation no. 14/2006
modifying CNVM Regulation no. 2/2006
on regulated markets and alternative trading systems

National Bank of Romania
November 1, 2007

(*)= based on Draft Impact Assessment Guidelines prepared by CESR, CEBS, CEIOPS

Working Group Composition

Participants	Authority
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Main Steps of Process

- Problem identification
- Statutory goals at risk
- Proposed regulatory actions
- Policy options
- Stakeholder consultation - questions asked
- Consideration of feedback
  - problem identification and Cost Benefit Analysis of policy options
- Comparison of options and final policy recommendation

Problem identification

The **problem:** a previous attempt to address a market failure (insufficient capital in a securities exchange) had not been successful

- The original **market failure:** was an inadequate supply of capital which was threatening the maintenance and development of trading infrastructure on a securities exchange, heightening potential operational risks, and undermining market participants' confidence, for example due to limited market information.
- The subsequent **regulatory failure**: the regulation that attempted to address the market failure by setting minimum levels of capital was not enforced as it did not give the exchange enough time in which to reach the limit. The regulation also included restrictive ownership rules that preventing fresh capital from entering the market.
- **Market failure compounded by regulatory failure creates a challenging problem.**

Statutory goals at risk

- The problem identified poses risks to the following general goals of the regulating authority

» to **promote confidence** in regulated markets and investments in financial instruments;

» to **promote the adequate and transparent functioning** of regulated markets;

» to **prevent fraud and unfair practices** on regulated markets.

Proposed regulatory actions

Broad principles:

1. To address regulatory failure that prevents addressing market failure
   - To set a feasible time horizon for capital raising given market realities
   - To remove unnecessary restrictions on sources of capital for exchanges
2. To address market failure
   - To review minimum capital levels
     - Adequate resources to comply with transparency requirements following EU accession

Policy options

Option 1. (“**Do nothing**”). Under the baseline regulation, market operators need to reach a capital of EUR 5 mil. by the end of 2007 with market intermediaries holding majority voting rights.

Main option: **“Remove capital source restrictions”** and

either

Option 2. (“**Time extension**”) A mandatory equity level of EUR 5M to be reached in three steps, by the end of 2008. Also, it will no longer be mandatory to have majority voting rights being held by intermediaries.

or

Option 3. (“**Lower capital requirement**”) Market operators allowed to reach a lower mandatory equity level of EUR 2M in two steps by the end of 2007. Also, it will no longer be mandatory to have majority voting rights being held by intermediaries.

Stakeholder consultation

- ➢An explanatory cover letter and questionnaire were sent to selected stakeholders:
- Market Operator;
- Market Operator shareholder (Intermediary).

- ➢ Main issues in questionnaire:

  a) the nature of the problem,
  b) identification of the costs and benefits of the regulation and of two alternative policy options.

➢ Last step: face-to-face meeting to quality check all stakeholder responses and enhance the Working Group (WG)'s understanding of their answers.

Feedback Goals

- Have we diagnosed the problem correctly or are we missing other elements that place statutory goals at risk?
  - To minimize regulatory failure risk

- Are there other factors at play, in addition to capital, that affect trading efficiencies?
  - Their respective relative importance may help determine minimum level of capital and time needed to reach it.
    - Policy flexibility helps address regulatory failure risk and identify other tools to address market failure.

Questions Asked (1)

Question 1: ***"Problem accurately represented"***

Do you agree with us that the problem is as described?
Please explain your answer, including evidence (or suggesting the type of evidence that would be relevant) where at all possible.

Question 2: "***Does trading efficiency require a particular level of capital*** "

In your opinion, **what are the factors that can contribute to ensuring the adequate maintenance and development of the trading infrastructure**, covering for potential operational risks, providing comprehensive market information and securing market participants' confidence?

The questionnaire suggested some factors:

- Market operators capitalization;
- Trading and other types of commissions earned by market operators;
- Increase of diversity of services offered by market operators;
- Affiliation to international professional bodies (e.g. World Federation of Exchanges WFE, Federation of European Securities Exchanges FESE);
- Mergers with other market operators (e.g. NYSE Euronext).

Questions Asked (2)

Question 3: “*Factors other than capital affecting trading efficiency*”

Please estimate the importance of the above mentioned factors for securing the adequate maintenance and development of the trading infrastructure, covering for potential operational risks, providing comprehensive market information and securing market participants’ confidence.

Respondents were required to rank the factors’ importance as high, medium or low.

Question 4: “***Is market operator sole provider of trading efficiencies***”

We assume that the market operator is the only entity which can secure the adequate maintenance and development of the trading infrastructure, cover for potential operational risks, provide comprehensive market information and secure market participants’ confidence.

Do you think that third party providers (e.g. professional associations, etc.) could ensure some of the above mentioned objectives? Respondents were required to explain their answers, including evidence.

Questions Asked (3)

Question 5: "***Through which channels does capital affect trading efficiencies***"

The **enactment of Regulation no. 14/2006 has coincided with the following effects: narrower spreads, increased liquidity, increase in new investors, increase in trading volumes, introduction of new instruments, etc**. Do you think that this **is wholly due to the increase in capital held by the exchange or can other factors explain these evolutions?**

Please explain your answer, including evidence (or suggesting the type of evidence that would be relevant) where at all possible.

Under this question, respondents were asked:

a) to provide details on how their firm was affected by the new regulation before and after it was issued; and

b) if they think that this is wholly due to the increase in capital held by the exchange, or can other factors explain these evolutions.

Stakeholders were also asked to explain their answer, including evidence (or suggesting the type of evidence that would be relevant) where at all possible.

Questions Asked (4)

Question 6: ***"…And how would you quantify impact of capital level on market indicators***"

Stakeholders were asked **to estimate the influence of the market operators' capital increase on the aforementioned capital market indicators.**

Respondents were required to rank the influences of the prescribed capital increase over the listed effects as high, medium or low.

Feedback & Response: Statutory goals at risk

Feedback from consulted stakeholders

Stakeholders estimated that market operators' capitalization was not very important to achieve the objectives above indicated. In addition market operators' affiliation to international professional bodies was not rated high.

Our response was that the regulation under scrutiny had a significantly positive impact on the factors identified, which are key to address the objectives set by the regulator - to ensure the adequate maintenance and development of the trading infrastructure, to cover for potential operational risks, to provide comprehensive market information and to secure market participants' confidence.

Cost/Benefit Analysis – feedback and review

When asked if the market operator is the only entity which can secure the adequate maintenance and development of the trading infrastructure, cover for potential operational risks, provide comprehensive market information and secure market participants' confidence, stakeholders answered that **the market operator cannot be the only entity** but rather that other players should have a role (e.g. **post-trading operators**, such as clearing houses.)

When asked to consider the extent to which the regulation was responsible for the observed narrowing of spreads, increased liquidity, increase in number of new investors, increase in trading volumes, and introduction of new financial instruments, respondents answered it had a low influence with regard to all the above factors, save for the number of new intermediaries.

In our view, this is true, yet it leads to a different matter – there are very demanding capital requirements for post trading entities, too, and these are the object of **different regulations**.

There were also remarks on competition being discouraged, since one entity gave up getting authorized as a market operator; we believe this was not caused by the mandatory capital level, but since it saw better business opportunities in a different area and subsequently getting in line with other legal provisions. The new regulation was **not targeted** to a certain entity and compliance was required from all operators.

Comparison of the options

Comparison of the three options was difficult because they represented close variations of the same basic approach (ie the adoption of a capital requirement by a specified point in time). This meant that stakeholders' responses weren't clearly differentiated. Since the CBA case was not clear we made the following judgment:

Option 1 - "do-nothing" would be definitely detrimental, since it would bring about the loss of one Market Operator and subsequently a temporary closing of a domestic market, which already has a tradition and its own infrastructure. This infrastructure (post-trading institution) would have been adversely affected, too.

Option 2 is seen as better than **Option 1 and 3**, although it involves some costs, and its market impact is perceived as rather low in terms of trading volumes, quality, quantity and variety of goods and services, product innovation, and high only as regards competition.

Option 3 , with minimum capital set at 40% of the present minimum, was judged to weaken market confidence, even though capital level is not seen as the overwhelming factor affecting market confidence.

Policy Recommendations

After reviewing the findings of this RIA exercise, the Working Group recommends issuing a new regulation according to **option no. 2** – actually, such were the provisions of the examined regulation, this being an ex-post impact assessment.

We may consider that the relevant policy proposal was properly implemented and achieved its objectives. Its effects were not obvious at the outset, and it should have been kept under constant review. The review resulting in the present RIA confirms that the option adopted was adequate.

As a final remark, we found out that stakeholders do not always share regulators' views and new conclusions may arise from a consultation, possibly leading to a change of policies, with the aim of getting an optimised result.

Annex

Cost/Benefit Analysis - findings

Impact on regulated firms

Costs were divided into subcategories, as recommended by the *Guidelines*, and they are supported mostly by the regulated firms. We could collect no evidence from consumers as to their prospective costs derived from policy options considered, and this is a shortcoming of our work that could be mitigated by more extensive consultation. Though some figures were provided by consulted stakeholders we did not use them, since they are quite dispersed and we found it difficult to check and match them for the purpose of this exercise.

We chose to assess the regulation impact only on the side of regulated firms, on a qualitative basis.

Cost/Benefit Analysis - findings (1)

Impact on regulated firms

A) Quantitative costs

Stakeholders identified (including quantitative assessments) **one-off and ongoing compliance costs** stemming from **option 1.**

Stakeholders' feedback for the **do-nothing option** (no. 2) says that **some one-off compliance costs** may be incurred whilst neither ongoing compliance costs nor other kinds of costs are expected on a significant basis.

When assessing **option 3**, stakeholders identified some compliance costs (both **one-off and ongoing**) as well as **costs for meeting equity compliance**.

B) Qualitative costs

For all three options, significant qualitative costs are not foreseen.

Cost/Benefit Analysis - findings (2)

Impact on regulated firms

C) Market impact

C.1. Trading volumes: Market participants agree that **options no. 2 and no. 3** would have a positive impact on trading volumes at **medium to low** level, while **option no. 2** would generate **high impact** on trading volumes.

C.2. Quality/quantity/variety of goods and services: Market participants agreed that **options no. 2 and no. 3** would have a **medium-to-low level impact**, while **option no. 1** would generate a **high impact.**

C.3. Product innovation: Stakeholders assessed that **option no. 2** would generate a **medium-to-low impact** on product innovation, while **option no. 1** would generate **high impact,** and **option no. 3** would generate a **low impact** on product innovation.

Cost/Benefit Analysis - findings (3)

Impact to regulated firms

C.4. Competition: According to stakeholders, **option no. 2** affects competition by discouraging the setting up of a new market operator.

For **options no. 1 and no. 3** stakeholders interviewed did not envisage competition-related issues.

D) <u>Benefits section</u>

While assessing **option no. 2**, respondents said that some benefit might arise for the market operator rather than for intermediaries. Moreover, this option allows the capital increase of the market operator to take place (in 2008) after the capital increase of the intermediaries.
Stakeholders interviewed did not think **option no. 1** could bring benefits.

In our respondents' view, **option no. 3** allows the outline of an intermediary step in the capital increase of the market operator.

Final text of regulation

"(2) The majority of the voting rights of the market operator shareholders shall be held by the intermediaries who are admitted to trading on a regulated market(s) managed by it, unless the instruments of incorporation stipulates otherwise."

2. Article 89 shall be amended as follows:

"Bucharest Stock Exchange and Financial Monetary and Commodities Exchange Sibiu shall respect the provision of art 7, as follows:

a) By 31 December 2006, the RON equivalent of minimum Euro 750,000 calculated at the reference rate announced by the National Bank of Romania on the date of submitting the request to increase the share capital;

b) By 31 December 2007, the RON equivalent of minimum Euro 2,000,000 calculated at the reference rate announced by the National Bank of Romania on the date of submitting the request to increase the share capital;

c) By 31 December 2008, the RON equivalent of minimum 5,000,000 calculated at the reference rate announced by the National Bank of Romania on the date of submitting the request to increase the share capital;