CSFI
CENTRE FOR THE STUDY OF FINANCIAL INNOVATION

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To: Members of the CSFI Advisory Council

From: Andrew Hilton

May 22, 2007

CSFI Advisory Council Meeting, April 24, 2007.

Among the ideas for follow up:
- Maxey paper on fragility of the global financial system;
- how serious is Project Turquoise, and will it make price data public?
- what is going on with other alternative exchanges and trading platforms?
- is there a backlash underway on fair-value accounting?
- is the price for IFRS adoption in the US too high?
- private equity – the ToR of the Walker Committee; and the differential tax treatment of debt;
- the regulatory implications of Scottish independence;
- the on-groining review of the Lamfalussy process?
- CESR's agenda under its new chairman, Eddy Wymeersch;
- the total cost of doing business in London, compared with NY – including such collateral costs as litigation;
- the FRC's new report on competition in the audit market; and
- the responsibilities of pension fund trustees in corporate actions.

A meeting of the Centre's Advisory Council was held at the City Club on April 24, under the chairmanship of John Plender. A list of those attending is given as Appendix I.

The main purpose of the Council is to structure the CSFI's work programme. This means that a lot of potential subject areas get discussed, and ambitious names are bandied about as potential speakers. Topics raised at this meeting included:

- **A recent paper by Henry Maxey, of Ruffer, on the weakness of credit markets, the shortcomings of the ratings agencies, the mis-pricing of lower-tranche collateralized securities etc etc:** Plender felt this paper is both provocative and well-argued, and well worth a round-table (which is now in train).

- **Project Turquoise:** There was curiosity (and scepticism) around the table. The Turquoise partners have appointed the DTCC as clearing and settlement agent, and are close to announcing a technology partner. But are they serious? Or is it still just

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a stick to beat established SEs with on the issue of fees? The problems for the exchanges are pretty obvious:

- what do they have to offer to head off Turquoise?
- the barriers to entry are low, if Turquoise is serious.
- the technology involved is not enormously expensive (though Jones disputed this); and
- there are lots of interesting models from outside the exchange space (Betfair, for instance, now processes more trades than the LSE).

The only advantage incumbent exchanges have is regulatory.

Winterflood suggested that price data may be a big issue. Will Turquoise let others use its price data?

It was agreed that we should try to find someone from Turquoise to talk. After all, as Huertas pointed out, this is a potentially positive development for the end-investor – not just for the partner institutions.

– **Alternative exchanges:** Leading from the Turquoise discussion, it was felt that we should look at other initiatives in this space – Plus, AIM etc – and particularly at the governance issues involved. There are also other specialist platforms that would be well worth looking at. It was pointed out, for instance, that MTS is looking at admitting hedge funds as direct members. ICAP, too, could become an alternative exchange. Perhaps Terry Smith might be willing to speak.

– **Post-trade infrastructure:** Ridley urged another look at this area – which is increasingly subject to scrutiny from EU competition authorities.

– **Fair value accounting and IFRS:** Green urged another look at what is going on. There appears to be a feeling that fair value accounting is much harder in Europe than in the US (*vide* the recent round-table with Nicolas Veron). There is also a feeling that some sort of reaction is underway.

Montagnon wondered whether the price David Tweedie is having to pay to get the SEC on board may be too high. Tactical compromises have to be made. But is Europe giving away too much? The row over fair value accounting (and the US fixation on exit prices) is part of that.

The other issue that came up is the potential fragmentation of IFRS. The SEC will only agree to reconciliation if there is only one form of IFRS. But, it was suggested, there are already signs that national variants of IFRS are developing, even within Europe. Is that such a bad thing? Or might there be advantages to competing standards? Should we let the investors do the work of choosing?

– **Private equity:** An obvious place to start would be the committee set up under the chairmanship of Sir David Walker. Can we get him along? He is supposed to look at the public interest issues involved.

What the Walker Committee will not look at are issues like the toppishness of the market, the sustainability of the industry, the possibility of a credit bubble – and even the impact on public markets. Chown noted that there are also important tax issues favouring private equity that revolve around the differential tax treatment of debt and equity.

Warland wondered whether we should look at the onerous quarterly reporting requirements on public companies that may be a major driver of private equity. Is private equity actually a better model of capitalism?

– **Climate change:** A tricky one, given the scepticism about the science evidence at the last round-table on the subject. However, Barber insisted that we need tax breaks to kick-start environmentally friendly technologies – and early stage investments. (A show of hands around the table suggested that the majority agrees CO_2 is *a* cause of global warming, but only a minority felt it is *the* cause.)

– **Scottish independence**: It was suggested that we should take a fairly robust look at Scotland's "dependency culture" and on the tax and regulatory implications of independence. Ben Thomson, of the Noble group, may be willing to speak.

One issue that might be worth exploring is whether Scotland's financial sector could continue to be regulated (on a delegated basis) by the FSA, post-independence.

– **Lamfalussy:** It was pointed out that the Interinstitutional Monitoring Group will complete its review of the Lamfalussy process by January 2008, and that it is now consulting with the industry. (Mark Harding, at Barclays, is a member.) A preliminary report will be submitted in September.

Apparently, the European Parliament is also working on its own report.

The City has made its own submission to the IIMG, but there is a feeling that it may not get all of what it wants. One comment was that the Commission finds it "odd" that the City doesn't have a single strategy. The danger is that, out of this review, the spectre of a pan-European regulator may again rear its head.

Linked to this, Norman suggested that we should approach the new chairman of CESR, Eddy Wymeersch, to speak about this agenda (as we did with his predecessor, Arthur Doctor van L).

– **London/New York:** There is still plenty of mileage in this debate. James suggested that the key issue is the total cost of doing business, and said that Peter Taylor at Loughborough has done interesting work in the area. (He is a professor of geography, and co-director of the globalisation and world cities study group.)

The litigation culture in the US is also an issue. Is the US less attractive to issuers because of litigation and class action suits? If so, we may have a problem since we are going in the same direction. Montagnon suggested an approach to Bill Lerach – a US securities lawyer who sees the UK as ripe for class action suits. (Potential respondents would be Mark Anson at Hermes, and/or Barbara Thomas Judge.)

- **Audit:** Green gave a plug for the FRC's recent paper on competition and choice in the UK audit market. This is an immensely important subject.

- **Pension fund trustee responsibilities:** Jacomb suggested another look at the ability (and obligations) of trustees to interfere in corporate actions. What determines when pensioners have a say?

  In addition, there was the usual discussion of Basel 2, MiFID etc etc. On MiFID Warland subsequently sent a note suggesting that we should look at the impact of the "inducements clauses on the distribution of mutual funds in particular". He felt that pressure on front-end fees could be disastrous for continental European institutions. (He also suggested we look at UCITS III, which, he said, would allow "all sorts of toxic, and geared, waste" to be injected into UCITS – risking disaster down the line.)

  Other potential issues that were brought to our attention by people who could not attend included:
  - how the personal debt/insolvency problem is now being handled in the UK (Geoffrey Fitchew);
  - Islamic (*takaful*) insurance, and the regulatory issues surrounding it (Matthew Connell);
  - the US subprime market and the agency problem (Brandon Davies);
  - do the World Bank and IMF now do more harm than good to emerging markets (Brandon Davies)?

Appendix 1

Meeting of the CSFI's Advisory Council, held on Tuesday, April 24, 2007, at the City Club, 19 Old Broad Street, London EC2N 1DS, from 6:00-8:15pm, under the chairmanship of John Plender.

Chair	
John Plender	Financial Times
CSFI	
Andrew Hilton	Director
Tim Jones	Co-director
David Lascelles	Senior Fellow
Eleanor Laws	Funding Coordinator
Sam Mendelson	Programme Coordinator
Members	
Martyn Baker	City of London
Richard Bostock	FLA
Jon Carr	UBS
Sheenagh Gordon-Hart	JP Morgan
Susannah Haan	Fidelity International
Martin Hall	FLA
John Hitchins	PricewaterhouseCoopers
Thomas Huertas	FSA
Kevin James	Bank of England
Alexander Justham	FSA
Jerry Norton	LogicaCMG
Alan Punter	Aon
Brian Winterflood	Winterflood Securities
Guests	
Jonathan Barber	Glenfern
Robert Bruce	
Jane Fuller	Fuller Analysis
Florian Gampe	Herbert Smith
David Green	Financial Reporting Council
Sir Martin Jacomb	
Rosamund McDougall	Optimum Population Trust
Peter Montagnon	ABI
Paul Myners	Myners
Peter Norman	
Sir Adam Ridley	Equitas Trust
Brian Scott-Quinn	ICMA Centre
Paul Seymour	FRC
Philip Warland	Halsey Consulting