"How can regulators do better the next time?"

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1. Introduction

It is my great pleasure and honor to be invited to speak at this year's CFTC International Regulators' Meeting. It is extremely useful and timely to talk about how we should deal with such new issues as block-chain and distributed ledger technologies, as well as some not-so-new topics of automated trading. I certainly look forward to a fruitful and interesting discussion.

On my part, I would like to offer some of my recent thoughts about regulatory reform concerning OTC derivatives markets and, more broadly, reform around financial markets and FMIs.

The conclusion I draw from my thinking is that, while we have made a lot of progress in designing the new regulatory framework for an increasingly globalized market, we have had, admittedly, some siginificant problems in ensuring consistent and timely implementation of the agreed measures. We still have a lot to do in completing the fine details of the rules, as well.

In so doing, I need to make this disclaimer that any views I express today will be my own, and not necessarily identical to the official views of the JFSA.

2. Progress so far in regulatory reform concerning OTC derivatives and the great challenge ahead

First, one should not understate the fact that the main pillars of reform have increasingly entered the implementation phase, after huge efforts made during the past 7 years in designing the post-crisis regulatory framework. In other words, the design phase is coming to an end. Of course, many of the reforms require further work in fleshing out the details, and the devil may still be in the details, but this is a major achievement. I am sure a lot more also needs to be done in providing greater transparency and accountability over the new rules, but some major elements of uncertainty are finally being removed in many jurisdictions.

Second, however, this does not mean that the challenges of implementation, which is our current focus, will be any easier. In fact, there is a major issue here in how to achieve consistent and timely implementation of the new measures, and regulators still have a lot to do. When I refer to consistency in implementation, there are at least three important consistencies involved: i.e. i) consistency with the economic policies of governments in promoting growth, employment and providing finance for growth, ii) consistency across sectors and markets, not giving rise to regulatory arbitrage or market distortions, and iii)consistency across jurisdictions.

Again, on all those fronts, we have been making progress, but I must state that the progress has been relatively slow in ensuring the three consistencies I referred to now, and the results are still, admittedly, patchy. With all due respect to the huge efforts of governments in addressing those issues, I find that there is a cross-cutting problem here: regulatory reform has suffered from a certain "silo" mentality of the different regulatory and supervisory agencies across jurisdictions, and a symptom of "fallacy of composition", or, in some cases, perhaps "a fallacy of the herd mentality".

This is not to say that efforts to coordinate the work across different regulators and across jurisdictions have not been undertaken by the G20 and FSB. It is only that a lot more efforts to coordinate, as well as having an effective and efficient framework to ensure the consistency of policies may be needed at the global level.

The OTC derivatives market reforms are a case in point. In undertaking OTC derivatives market reform, we had three main objectives: mitigating systemic risk; improving transparency; and protecting against market abuse. The measures to achieve those objectives have been introduced and are now being implemented on a jurisdiction-by-jurisdiction basis. While this is in itself a major achievement, the problem is that jurisdictions have adopted different implementation timelines and different detailed rules, which were not consistent with each other in their fine print. Mutual recognition and determination of comparability or substituted compliance then became extremely complex and laborious, taking time to complete. It is still on-going today.

Quite naturally, this has given rise, unfortunately, to a lot of concern on the part of market participants. In some cases, those inconsistencies and lengthy processes were interpreted as measures to protect national interest, and not as measures to ensure the integrity and transparency of the markets, as originally conceived. It is time that regulators responded to such misgivings and expressions of concern more squarely, and explain what we are after, collectively.

An obvious course of action is to step up our efforts in the regulatory community to dissipate uncertainties and speed up the processes for ensuring consistent and timely implementation of the reform measures in a concerted manner. With the best of intentions on the part of everyone involved, I can mention that this is starting to happen already, but progress is slow once we have allowed ourselves to work differently, both in terms of substance and timing. That is, much better coordination is needed across different regulators of different jurisdictions.

There are three particular challenges for regulators in approaching the issue of better coordination in setting the details of the reform measures and implementing them consistently. First, the reform measures should be agreed as much as possible in a granular fashion, while leaving room to adjust when there are real and material differences in the markets in question of different jurisdictions. Second, if it becomes evident that there are inconsistencies or differences between the rules of jurisdictions, there needs to be a process for assessing those differences and addressing them where they give rise to unintended consequences. Third, given that some differences will still remain even after all efforts were made, we need to make good to the principle of an "outcomes-based approach", i.e to focus on the outcomes of the different rules and ask whether the rules produce similar regulatory outcomes, or, in other words, they equally achieve the common objectives of reform

to mitigating systemic risk, improving transparency, and protecting against market abuse.

In so doing, we need to overcome some persisting features of the current regulatory system in the financial area. By looking at what needs to be overcome, we can draw some lessons for the future.

3. <u>How can we do better the next time</u>?

So, how can we do better ideally, the next time?

Having chaired the IOSCO Board, and before that, the IOSCO Technical Committee when the Principles for Financial Market Infrastructures (PFMIs) were published, I believe in the value of having a set of agreed international standards at the outset. The ideal will be that we succeed in ironing out the differences that exist in existing rules across jurisdictions in the design phase of the new rules, and agree on a set of international standards that are sufficiently granular to resist cracks opening in the implementation phase, and apply them in a concerted manner following an agreed implementation timeline.

Actually, we have come very far in the regulatory reform of the OTC derivatives markets, so we cannot immediately go back to the drawing board, honestly speaking. But we can perhaps improve on the PFMIs, for example, to make them more granular where we can find consensus and have countries actually implement them in accordance with an agreed timeline, and not go their own directions going forward.

But then, even if the rules of jurisdictions are essentially converged in accordance with an agreed set of international standards, they will never be identical, and regulatory approval could still be uncoordinated, due in part to a lack of resources at the regulator, and for other reasons. This means there will be a need to resolve conflicts, inconsistencies and overlaps between rules of different jurisdictions, when and where they occur.

So, for the future, I can make three practical suggestions on actions to be taken by regulators:

i) Agree as much as possible on sufficiently granular standards, and so far as those standards are followed by jurisdictions, be in a position to determine equivalence or comparability of regimes of other jurisdictions in a speedy manner.

ii) Agree on a realistic timeline to implement those new rules across jurisdictions in a concerted manner.

iii) Make sure domestic rules of jurisdictions incorporate sufficient flexibility and ability to adjust the details of the rules if needed to ensure cross-border consistency of the rules, and in accordance with any unforeseen market developments.

In forging such agreements, and in making sure domestic regulation is not too

constraining for international coordination, there needs to be an international body that enables such concerted action. Currently, CPMI-IOSCO may be in the best position for taking such coordinated action, but it has become apparent that there needs to be strong coordination with the Basel Committee as well, and there is room for improving coordination between prudential and market regulators in this respect.

You may think that I may be day-dreaming when thinking about the current rather complex situation we are in, but in some areas we are doing better than in others.

4. <u>Coming back to reality – Ongoing work</u>

Having felt the threat of market fragmentation, we have made some recent progress in reconciling differences in the rules of jurisdictions as they apply to cross-border transactions and activities. Some forms of deference to regulation and supervision by foreign authorities using such tools as mutual recognition, substituted compliance, or other measures have become necessary, and are being arranged between authorities of different jurisdictions. In this context, it is good to know that there was some further progress made by the authorities of Europe and the US with respect to rules applying to CCPs operating cross-border, but this process has been very time-consuming and difficult, to say the least.

There is now a joint work-plan on the recovery and resolution of CCPs between the FSB and the relevant standard-setting bodies to coordinate their respective international policy work aimed at enhancing the resilience, recovery planning and resolvability of CCPs. The agreed work-plan focuses on CCPs that are systemic across multiple jurisdictions, consistent with a G20 mandate, and is hoped to fill a certain gap that exists across jurisdictions on the rules applicable to the recovery and resolution of CCPs. Differences in the rules applied across jurisdictions are still very large in this area.

When designing the resolution regime, I suggest we consider two important aspects: 1) a requirement for CCP participants to contribute more to the recovery and resolution of a CCP could create an incentive to return to non-centrally cleared transactions, which runs counter to our policy of promoting central clearing; i.e. this calls for a need to overcome the silo mentality and look more holistically at the incentives in play, and 2) one may need to establish a backstop to enable an orderly resolution of a CCP in difficulty with official intervention, in case the recovery and resolution framework as a whole does not necessarily work as intended in a crisis. This latter backstop could be designed so that an orderly resolution could be undertaken immediately when needed, without disrupting the core operations of a CCP. It can also be designed that any loss is borne by industry contributions and not by the taxpayer. In Japan, we are currently considering including FMIs such as CCPs in the framework for orderly resolution of financial institutions, which would provide such a backstop.

Trade reporting is also an area which requires stronger coordination across jurisdictions. A working group at CPMI-IOSCO is currently developing standards for data reporting, including the UTI and the UPI, aiming at facilitating global data aggregation. Although steady progress is being made towards harmonizing data

across jurisdictions, a number of issues such as data governance and maintenance still lie ahead and are being worked upon.

In margin requirements for non-centrally cleared derivatives, we managed to agree on a set of measures and a timeline for implementation in a joint working group of the Basel Committee and IOSCO. The deadline was extended by nine months last year, but this was also in agreement among the major jurisdictions.

Although there are still some differences in the detail to be applied by each jurisdiction, the hope is that this becomes a certain success story in the overall effort for more international coordination. In the case of Japan, at this very moment, we are still looking at the fine-print of our rules to implement those margin requirements, and we might make a few more technical changes to our draft. The US rules have been finalised, and we found them more aligned with what we had been calling for than initially thought, and some flexibility seems to be available in the details, which we welcome.

The last step in implementing the requirements is the establishment of equivalence or substituted compliance across the major jurisdictions, which is essential in avoiding duplication and inconsistencies creating difficulties for cross-border activity. To meet the deadline of September 1st this year, we need to speed up our work in this respect.

Now, what can I suggest for the course of regulatory reform in other non-US, non-European jurisdictions? I have always called for an approach based on proportionality and appropriate sequencing to be allowed for jurisdictions with less developed markets, particularly in OTC derivatives market reform. Such flexibility should not be used as an excuse for avoiding or delaying necessary reform, but one needs to be realistic in this sense. In my view, at least, having an explicit recognition of flexibility for jurisdictions with less developed markets could actually be a certain boost to implementation of the necessary measures in those jurisdictions, not an impediment.

5. <u>Approach to new risks and new technologies</u>

The main topics to be discussed today are centered on how regulators should deal with developments in technologies, and what opportunities as well as risks those technologies would bring. I will try not to go into depth on those subjects, as I would like to learn more from our experts on those points before proposing regulatory solutions.

If I make just one general point about our approach to those issues, it will be the following. That is, regulation cannot be ahead of technological developments. If regulation tried to pre-empt or ex ante determine the course of technological development, we are bound to fail, or, worse, we may well stifle innovation which could bring benefits to the markets and market participants.

This observation points to a need for regulators to always carry a sense of humility and the need to have a pragmatic and flexible approach to regulation in those new areas. We need to go back to the basics of our regulatory objectives, and

consider how we can best harness the benefits that those new technologies bring without harming consumers. Creating transparent, fair and efficient markets and protecting investors is always our objective, and we have to act flexibly and decisively to achieve this goal.

In my country, we just submitted a draft piece of legislation to our Diet to regulate exchanges of virtual currencies, while facilitating the use of new technologies by banks through deregulation. This will only be the first step of regulatory reform pertaining to the increased use of new technologies in the financial area in our country.

With regard to innovative technologies such as the distributed ledger and block-chain technologies, their potential may be great but there is considerable uncertainty in how they will transform the financial services markets and payment systems. Regulators should monitor the development of such technologies closely, but may well take some time in designing the appropriate regulatory framework over those activities in the future. If there are immediate concerns of consumer protection or financial stability issues involved, we need to apply our existing rules proactively, of course. But in a rapidly changing landscape, preemptive regulation could quickly become obsolete, and an impediment to innovation.

Such a step-by-step approach may appear overly cautious and tedious to some, but my view is that it will also guarantee more flexibility and pragmatism for the future. In the end, confidence in the integrity and transparency of the markets needs to be secured for such technological "disruptions" to become prevalent and beneficial. Regulation is part of that framework that builds and supports that confidence.

A certain caution may also be warranted when considering the regulatory response to high frequency trading (HFT) and algorithmic trading. Such trading has existed for some time by now, but is still evolving and taking up an even greater share of total trading in markets worldwide. Within the existing regulatory framework, we have introduced certain mechanisms to prevent excessive volatility and ensure orderly continuation of trading even in stressed conditions, such as circuit breakers and "speed controls" on order flows. To the extent that such technologies contribute to efficient price formation and liquidity, overly restrictive regulation could be counterproductive in achieving the objective of market regulation I described earlier.

In our country, the proportion of automated trading has been steadily increasing over the years, but, fortunately, there have been no major disruptions so far, with the exceptions of some temporary trading halts due to under-capacity of trading systems which have been subsequently remedied. This overall success may be attributed to the enhanced trading systems and safeguards which have been introduced over the years at the major exchanges, but we can never be complacent. At the JFSA, we are now conducting a study of the current state of financial markets, and, based on the outcome of this exercise, we may consider policy responses. International discussions at IOSCO and other forums will help us in setting the course of our policy work, in working towards "better regulation" of markets.

6. Conclusion

I have tried to provide my assessment of where we stand in our regulatory efforts both in design and in implementation, with a number of suggestions for doing better, the next time as well as in our immediate work. However, the reality is quite complex, and progress still takes time. I hope that an elevated understanding of the difficulties and a collective willingness of stakeholders globally to do better, in building the basic infrastructures for a sound and efficient international capital market, would provide the right impetus to overcome those challenges in the future.

I hope today's discussions will provide some useful insights on how we should proceed in this collective effort going forward.

Thank you very much.