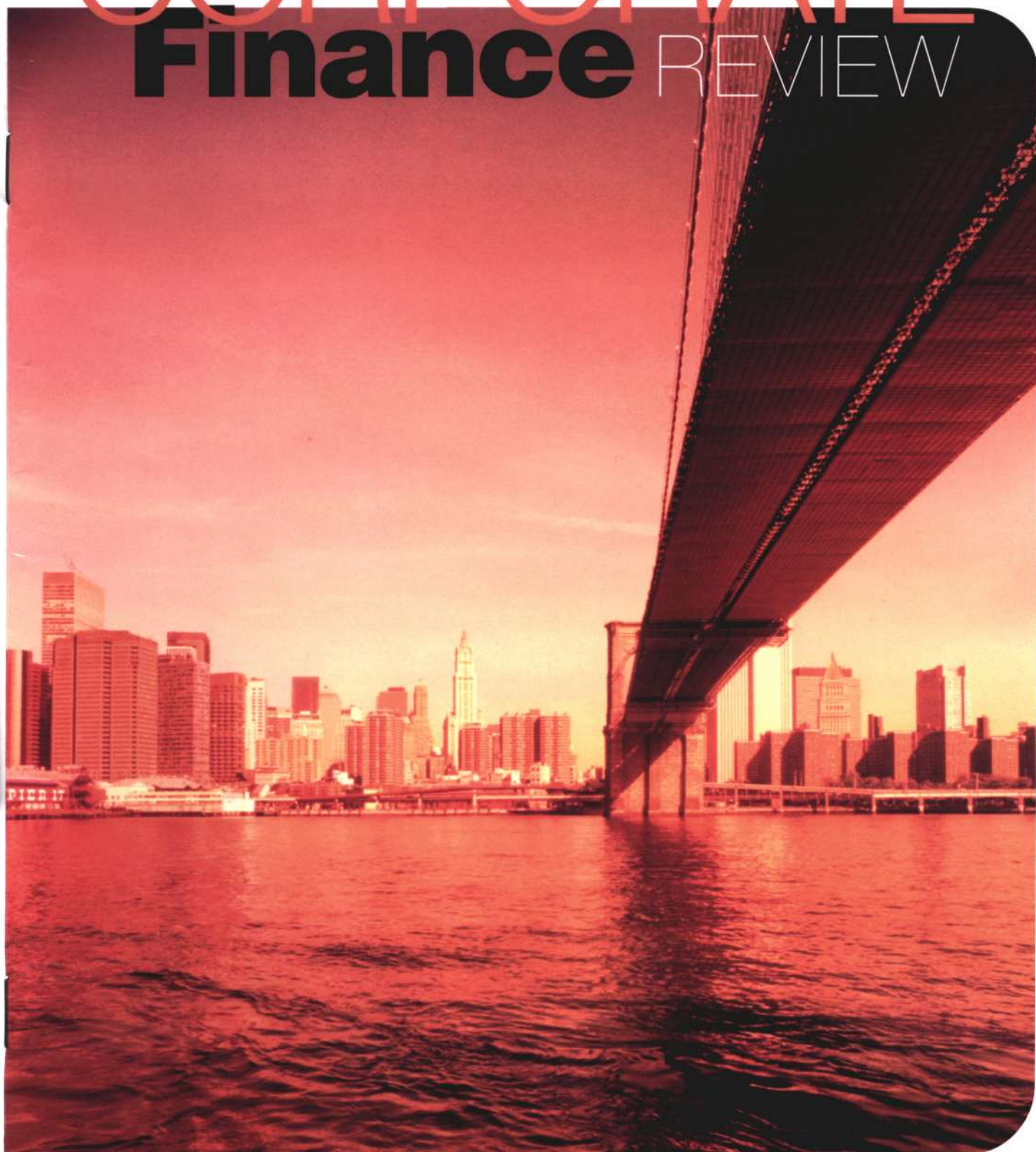


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THOMSON REUTERS

GLOBAL CAPITAL MARKETS AND CORPORATE COMPLIANCE REFORMS AHEAD: THE G-20 TACKLE THE ISSUES

For at least seven decades—since the dramatic collapse of the American stock market in 1929 and the adoption of financial markets oversight in the following years of the Great Depression—laws and rules addressing market reforms and the protection of investors have been mainly national pursuits. In the last three decades, as part of the globalization of *everything*, collaborative rule making has been on the rise. For example, the Basel Accord reached in the 1980s for oversight of commercial banking. All major banking institutions were expected to comply with the Accord to assure the safety and soundness of domestic and global banking.

Financial professionals can expect to see more global cooperation and attempts at the harmonization of rules following the dramatic upheavals that took place in 2008 in the world's capital markets. The failure of so many leading institutions (Bear Stearns, Lehman Bros, Merrill Lynch, among others) in the US and the intervention in banking and financial services by leading governments signals a more vigorous and coordinated approach by sovereign states and their unions in the months ahead.

Globalization brings vast opportunities in *everything* to local and regional economies—the freer movement of people, goods, ideas, capital flows, cross-

border investments—and also greater risk of failure because of the sharing of (or transfer of) risk due to the ease of movement of investment vehicles. Thus, the innovations in US capital markets that brought investors mortgage-backed securities (MBS) also infected the central banks of the Euro-

pean Union when those instruments (in which they invested) began to fail in the marketplace. Risk was more or less "instantly" shared or transferred among investors. No one was spared.

So, in mid-November 2008, the leaders of the world's largest economies descended on Washington, DC at the invitation of President George W. Bush to confer and agree on a way forward for capital markets reforms and increased (and more effective) oversight of financial services organizations, banking, and the corporate sector.

The G-20 travel to Washington, DC

The usual heads of state were there along with some new faces, such as leaders of what investment bankers Goldman Sachs identifies as the most powerful growth economies, the "BRICs": Brazil, Russia, India, and China. The leaders of the resource-wealthy nations such as Saudi Arabia were there as well. Each of these nations is affected by the market turmoil that began in 2007 in the US, and each is concerned about the present state of the credit markets and global investment flows. *Something must be done*, they all agreed. Expect many more suggestions for investor protections, rules for the banking sector, transparency in the capital markets, measures to address conflicts of interest, and a tight focus

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**THE G-20 WILL HAVE
SPECIFIC
RECOMMENDATIONS
BY THE END OF
MARCH 2009 AND
WILL MEET AGAIN IN
APRIL.**

on such things as corporate financial reporting and executive compensation.

The one-day meeting at the invitation of the White House was covered briefly by the major press, but financial executives should pay close attention to the follow-up to this meeting and how the recommendations to come from G-20 collaboration will affect them and their organizations.

The G-20 reached consensus on a number of short-, intermediate-, and longer-term agenda items, beginning with the following set of underlying principles to guide their work:

- The causes of the current financial crisis are known now to all players: Too many market players chased ever-increasing yields while not understanding or appreciating the increasing risks.
- There was too little regulatory oversight of this expanded risk taking, especially in the financial services and banking sectors, as well as too many *unregulated* financial instruments being present in the world markets.
- Despite the current turmoil in the financial markets, it was agreed that free market principles *are* important and must be maintained and encouraged by all nations. (And by extension, more effective regulation of the capital markets and corporate oversight is important to free-market principles.)
- Existing open trade and investment regimes — such as cross-border investments — should continue unimpeded. (The national leaders agreed *not* to impose new barriers to current flows in the face of deteriorating economic conditions.)
- The leaders agreed that more effectively regulated financial markets will encourage the "dynamism, innovation, and entrepreneurship that are essential" for economic growth, employment, and the reduction of poverty.

With all the drama going on in global capital markets, the G-20 stressed that they remain committed to cooperating as they address other critical issues,

including energy security, climate change, security of the global food supply, the rule of law, the fight against terrorism, and eliminating poverty and disease.

Specific market reforms to monitor

The G-20 departed Washington apparently in agreement—work begins immediately on market reforms within individual countries to develop specific action recommendations for consideration by the group. The G-20 will have specific recommendations by the end of March 2009 and will meet again in April.

Meanwhile, the 111th US Congress will begin its first term in January, and President-elect Barack Obama and his new cabinet will begin their work after January 20—banking and financial market reforms will be among the priority agenda items in the US capitol. A dual track approach is anticipated, which will consider necessary reforms for the US with an eye toward the harmonization efforts of the G-20 (which, of course, the US is a part of). Financial professionals should monitor the following:

- Multiparty or multinational efforts to collaborate on rulemaking (e.g., the effort at harmonizing accounting rules by the Financial Accounting Standards Board in the US and the International Accounting Standards Board of the EU).
- The global Basel banking agreements will be a part of the collaborative effort to address measures regarding banking safety and soundness.
- Potential reforms for financial institutions will be in store to assure more transparency and stronger risk-management measures, which the G-20 leaders agreed are important for preventing another financial crisis.
- New or strengthened rules flexible enough to encourage market innovation in banking and financial services.
- More transparency in financial instruments, especially for the variety of complex investment vehicles developed in recent years.

- Steps taken to avoid conflicts of interest among capital markets players.
- Strong oversight of the credit risk agencies. (Watch for heated debate concerning this in the US Congress, which has already summoned the heads of these companies to testify.)
- More international cooperation among nations, while preserving domestic regulation and enforcement of national markets. The Group of Twenty is considering the creation of "colleges" of banking and financial regulators to confer on needed actions and oversight. (This could help market overseers keep up with financial services innovations, such as credit default swaps.)
- The G-20 will take a closer look at accounting rules, especially corporate disclosure standards. Watch the debate over the "rules-based" US generally accepted accounting principles vs. the "principles-based" International Financial Reporting Standards intensify as the G-20 collaboration accelerates.
- Off-balance-sheet vehicles will get a close look in the reforms to be proposed.
- Closer examination of financial services organizations' capital reserve requirements—especially for structured credit and securitization.
- Summit participants were requested to bring their best practices in oversight of hedge funds to the G-20 as the group considers the regulation of hedges and private investment pools.
- New rules will be recommended to assure greater transparency of the credit derivatives markets and to reduce derivatives risk.
- Executive compensation was clearly an important item on the G-20 agenda; it was agreed that regulators would take a close look at enterprise risk taking and innovation and the management rewards for performance. (Expect continuing consensus at least on the agreement that each nation should be involved in some way in the oversight of pay vs. performance.)
- Regarding international financial institutions, the G-20 agreed to examine the mandates and governance structures of the World Bank and International Monetary Fund (and others)—this is of special concern to the emerging economies.

Global approach: local rules + global rules?

High on the agenda of the G-20 leaders was the topic of *risk*. We can view this as the *raison d'être* for the new spirit of cooperation on market reforms among the leaders of the world's largest economies, along with the natural companion of risk: *fear*. Fear that without effective regulation and oversight, *this could happen again*.

So as the world leaders headed back to their home countries, they issued a comprehensive communique, outlining study and research and fact-finding just ahead, and the action steps that market players could expect in the weeks and months to come.

The New York Times reported that the summit participants firmly agreed on these critical points:

- The world's financial markets must now be made more transparent.
- The use of derivative instruments must be addressed globally.
- Regulation must be coordinated among nations.
- Executive compensation must be addressed more broadly (noting that the US's excessive CEO pay practices are becoming a global issue).
- The concept of establishing a "College of Regulators" to share information across national borders seemed to find broad support among the delegates.

The summit's declaration of progress

The *Declaration of the Summit on Financial Markets and the World Economy* issued by the G-20 at the close of the one-day meeting underscored that consensus was reached on possible ways forward: "We are determined to enhance



**EXECUTIVE
COMPENSATION
WAS CLEARLY AN
IMPORTANT ITEM
ON THE G-20
AGENDA.**

our cooperation and work together to restore global growth and achieve needed reforms in the world's financial systems."

Deadlines for study and action steps were set at the summit. There will now be broad discussion of capital market and banking reforms within in the United States, and this will certainly be a top priority for the outgoing and the new administration and the next Congress. The deadline for an initial list of recommendations was set for March 31, 2009.

The current world crisis in capital markets in both the developed world and among emerging nations reflects the dramatic *inter connectivity* of ongoing globalization. The meeting of the G-20 leaders reflects the fact that they realize this and are committed, at least for now, to addressing a wide range of reforms domestically and collaborating with a family of free-market nations. The work has begun, and the stakes of that work are high—especially for financial professionals. •