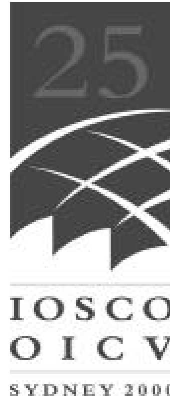


25th IOSCO Annual Conference
Sydney, Australia

# PLENARY 3
# The Regulator

## 17th May 2000

David Brown
Chair
Ontario Securities Commission

# The Regulator in Transition: Addressing the New Realities of the Marketplace

**The Regulator in Transition:**
**Addressing the New Realities of the Marketplace**

I appreciate this opportunity to discuss the evolving role of the regulator, and to hear global perspectives in a time of unprecedented change in the sectors we regulate.

One thing we are all becoming increasingly aware of is the fact that regulation is not static, because the market is not static.

We are seeing changes in who invests. It was once a preserve of the wealthy few. Increasingly, it is becoming an instrument of the middle class. In continental Europe the trend was slower to grow than in the U.K. or North America. But now the OECD reports that stock market capitalization is greater than the national GDP in Switzerland and the Netherlands. Since 1981, the stock market capitalization has increased several fold in France, Spain, Germany and Italy.

The Toronto Stock Exchange estimates that close to 40 per cent of adult Canadians are invested in the markets, through pension funds, mutual funds, or direct retail investments. Estimates for the United States are even higher. A generation of savers has given birth to a generation of investors.

The tremendous growth in retail investing has helped to fuel a significant shift in activity to the secondary market. Regulators who used to concentrate on initial offerings must now broaden their focus.

We are seeing just as much change in <u>where</u> people invest: wherever it meets their investment goals. Borders exist on maps. They are quickly disappearing from the marketplace. Globally-integrated markets are generating dramatically increased cross-border flows.

That was the driving trend even before the Internet burst on to our computer screens. Now, it's accelerating at cyberspeed. Jurisdiction has traditionally been based on geography. But you can't locate "dot.com" on a map. Increasingly there is one market: the world.

It's a 24-by-7 world of real-time communication where new financial products hit the marketplace at lightning speed. Modern technologies are allowing investors to act upon growth opportunities far more widely and quickly than ever before.

Just a few years ago, electronic trading was the exclusive province of professionals, with training, experience and dedicated terminals. Today, it's open to anyone with a computer and a modem – or even a cell phone or a personal data assistant.

Just a few years ago investors checked stock prices in the daily newspaper. Today, people check the price of stocks on the Internet, in real time. It used to be that one of the most important distinctions between a broker and a client was that one of them had access to a great deal of information, and the other one didn't. That distinction is withering away.

Technology is changing everything about the way we invest – from customer service, to the clearance and settlement of trades, to the very concept of what constitutes an exchange. We've seen the elimination of trading floors, and a growing proportion of investing is carried out in the virtual world.

Today's technologies – primarily the Internet – are shifting the financial world far more quickly than the telegraph and the tickertape did a century and a half ago.

Think about how long it used to take for a major new technology to capture a mass market. Electric power existed in the 1870s, but it didn't become universally available for about 50 years.

Compare that to how quickly major innovations are adopted today. The first Internet browser became available six years ago. Now it is used by hundreds of millions of people.

The pace of technological change is only going to accelerate further. For one thing, technology is cumulative. As Sir Isaac Newton pointed out, he stood on the shoulders of all of those who came before him. Tomorrow's innovators have even more shoulders to stand on. Moreover, the pace of innovation intensifies with the growing ability of markets to absorb it, and the shrinking time span required to pay down R&D start-up costs.

Technology is developing so quickly – and being disseminated so widely – that it is forcing markets to move at a far faster pace than ever before. Where at one time you might have spent years planning, developing and test-marketing a product, now you rush it out in months – before someone else gets there.

The same forces drive financial products. Financial innovations are improving processing speed, lowering transaction costs, and unbundling, combining and creating new financial instruments.

The fast-paced development of new products is helping to erase the lines that used to separate one financial sector from another. In many countries financial service providers were historically segregated by sector. Companies providing financial products fit clearly and neatly into a specific category: they were banks or they were insurance companies; they were securities firms or fiduciary estate-management institutions. In Canada, we called them the four pillars, and they were just as unmovable. There was very little overlap in products and services. Cross ownership was prohibited, or at least limited.

But the four pillars have melded together. As financial institutions matured, and in some cases demutualized and became listed companies, they found it necessary to branch out into a broader range of products and services in a continuing drive for growth. Increasingly, financial services are being delivered by conglomerates integrated across sectors, and across borders. It is becoming difficult to say what the core business of a given financial service provider really is.

Insurance companies, for example, which used to restrict themselves to selling life insurance or annuities, are now selling policies that have the same economic effect as a mutual fund. Banks are offering deposit accounts where the return depends on changes in the price of stock indexes or the value of a specified portfolio of assets. How is that different from a mutual fund?

The people selling the products are also becoming harder to distinguish. Roughly 75 per cent of insurance agents in the Province of Ontario also sell mutual funds. Whether or not they are regulated, and by whom, depends upon what they happen to be selling at a given moment. If it's a mutual fund, the securities regulator regulates them. If it's an insurance-based investment fund, they're regulated by an insurance regulator. Jurisdiction could change during the course of a conversation between agent and client.

In Canada, as in other countries, almost everything about the world of financial services seems to be converging – except the institutions that regulate them. The chasm between the regulatory world and the market is widening, creating regulatory overlap and duplication for financial firms, and gaps in the regulatory network for consumers.

Investors have a right to a regulatory regime that recognizes these new economic and demographic realities. How do regulators address this? I believe that we must assess whether we have the jurisdictional structure, the operating structure, the decision-making capacity, the resources, and even the mindset to regulate effectively in the 21st century – and we must go about making the changes that may be required to ensure our ability to do so.

For example, do we have the appropriate geographic jurisdiction?

Obviously, different countries will address the changes in the financial world in different ways. Australia's shift of responsibility for most financial service regulation to the federal level is a recognition of these trends. But it would be a political non-starter in Canada, where a commitment to provincial autonomy runs deep.

Canadian provincial and territorial regulators have tried to work within that political reality by pooling their authority on an issue-by-issue basis. This has allowed us to jointly introduce or propose policies to address significant industry change – including the need for continuous corporate disclosure in light of a growing secondary market, circulation of documents electronically, the governance of mutual funds, and the regulation of electronic trading services.

This cooperative structure has allowed us to shape a national policy on many issues such as electronic investing. Brokers have historically been expected to assess the suitability of a client's investment. The rule was introduced during an era when clients relied on their broker to provide advice about each investment they made. It was an era when securities was a sell-side market, with a sell-side machine aimed at generating commissions and promoting securities that brokerage houses bought in huge blocks. In short, the suitability rule was an attempt to reduce the impact of the broker's inherent conflict of interest, to help balance the scales in favour of the customer. But how realistic is that when investors trade online?

When the chief function of discount brokers is to make the trade rather than recommend it, why should they be expected to assess its suitability? That is why provincial regulators in Canada will now waive our long-time requirement for brokers to make suitability assessments when they are only executing transactions rather than advising on them.

By seeking consensus among all provincial commissions, we were able to shape a national policy. That may be a second-choice solution, but it is one that is politically feasible.

Another question to ask ourselves: What can we do to ensure the capability to deal with regulatory issues that cross <u>national</u> borders, such as the near collapse of Long Term Capital Management?

Actually, LTCM demonstrated the emergence of an international regulatory network. National sovereignty is not about to simply disappear. But what is appearing is the beginnings of an international regulatory network, tying together a virtual alphabet soup of agencies responsible for supervision and coordination of banking, insurance, and stock exchanges. Obviously, this must be a continuing priority for IOSCO.

Do regulators have the autonomy we need to adapt to the characteristics of the marketplace?

The speed of change demands a whole new mindset in terms of regulatory goals, priorities and operating philosophy. To keep pace, regulatory bodies cannot purely be in the position of enforcing regulations or even interpreting them. The dynamic nature of modern markets demands continual liaison and communication between the regulators and the regulated.

Regulatory bodies have to continually keep ahead of the market, with a level of expertise that at least matches that of market participants. For legislative bodies to try to maintain that role directly is to invite gridlock and frustration. The issues emerging in financial regulation will not make their way to the top of government's agenda until long after the urgent need for policymaking has passed, given the speed at which the issues are evolving.

In Ontario, the need for change in this area became apparent several years ago. To address it, the Ontario Securities Commission was given the status of a stand-alone, rules-making body. This has allowed us to react to change, even to anticipate it.

Do regulators have the resources we need?

If regulatory bodies are a line item in somebody else's budget, do they have the means to enforce their own rules, and the transparency to be accountable for them? Self-funding can be a crucial component of regulatory efficiency, accountability, and enforcement. Ontario recognized that two years ago when it made the OSC a self-funding organization, financed by fees on the industry, applications, and marketplace transactions.

One of the most important questions is: Do we have the jurisdictional structure to deal with financial sectors that are converging? When the regulated sectors are becoming increasingly intertwined, how long can regulators remain separated?

Our host country of Australia dealt with that question by revising its regulatory structure to address convergence – shifting from specialized regulation divided by sector to across-the-board regulation based on the actual function the regulators fulfill.

There may be little distinction among financial service providers, but there is a great deal of difference between the functions fulfilled by various forms of regulation. The goals of protecting consumers and maintaining the efficiency and integrity of the marketplace are distinctly different from the goal of prudence – reducing the risk of insolvency among financial institutions. The difference between market conduct regulation and prudential regulation can be felt in terms of the role, culture and mindset of the regulator, and its relationship to the institutions it regulates.

Market conduct regulation is based first and foremost on a commitment to transparency: ensuring that everyone has a fair base of information to allow them to make investment decisions. As securities regulators, transparency is part of our institutional DNA. It governs everything we do – including the way we orient staff, and how we communicate with stakeholders.

Prudential regulation, on the other hand, sometimes dictates non-disclosure – or at least delayed disclosure. In Canada, it is proposed that a bank will not be permitted to make public disclosure of the banking regulator's assessment of its financial viability, even if the banking regulator expresses concern. The goal is to prevent a run on the bank, rather than ensure a continuing flow of information to shareholders.

Faced with similar issues, different kinds of regulators respond with totally dissimilar approaches. A market conduct regulator would require immediate disclosure. A prudential regulator would say "not until after you close your doors – or until after we fix the problem".

It's difficult for a regulator to continually demand transparency in one area, but frequently block it in others.

For that reason – with all due respect to the U.K. Financial Services Authority – I believe that trying to consolidate market regulation with prudential regulation would be like merging fire and water: one would consume the other.

But the notion of providing cross-sector market regulation, as practised in this country, is a natural fit. Ontario moved to adopt this approach earlier this month, when the Minister of Finance announced in his budget that he would create a comprehensive financial services regulator. The new structure will combine the Ontario Securities Commission with the insurance and pension regulator, the Financial Services Commission of Ontario.

The new entity, [possibly to be] called the Ontario Financial Services Authority, will eliminate the mismatch between regulation and reality. Securities, insurance and pension regulators will no longer travel on different paths – no longer duplicate each other, no longer contradict each other.

A comprehensive financial services authority can ensure a consistent regulatory approach, eliminate public confusion as to who regulates what, offer one-window service for both consumers and providers, enhance the competitiveness of the financial services sector, and improve the overall investment climate.

We have learned a lesson that I believe applies everywhere: financial service regulation must become as integrated as the financial services industry.

Ladies and gentlemen, with more people investing in increasingly innovative ways, regulators can no more afford to become comfortable than those that we regulate. The continual challenge facing us today is to maintain the traditional principles behind regulation, while applying them to a non-traditional world. We've learned the value of integration; next lesson: innovation.

The marketplace is continually changing; our task is to constantly keep in touch with it. Our rulebook of regulations has become entrenched; our role is to relentlessly question whether the old rules still apply. Our economic world is growing, converging, and accelerating; our challenge is to ensure our continued relevance in it.

Thank you.