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New Market Structures and Regulatory Issues

(Giovanni Sabatini - CONSOB)

Distinguished colleagues, ladies and gentlemen,

First of all let me thank the Australian Securities Commission for having invited me to take part in this event and for the opportunity to share with you some thoughts about the regulatory issues emerging from the recent dramatic changes occurring in the financial market.

The new landscape of securities markets:

1. The landscape of financial markets is changing rapidly; securitisation and financial innovation, the leading role of (secondary) markets in intermediating flows of funds and as tool for managing risk, technological developments, the end of geographical barriers (remote access) and the end of exchange monopoly, "privatisation" and "demutualisation" of traditional exchanges, the consolidation of exchanges and of other market infrastructures (eg. clearing and settlement systems) are factors, among the others, that are contributing to dramatically reshaping the industry of financial services, the roles played by different market participants and the way in which they compete.

In the light of this changing world, one may ask where regulators stand?

2. Regulators should welcome financial innovation, competition and greater efficiency. However, they should also identify and assess the potential additional risks or shortfalls that may arise from such market developments.
3. Notwithstanding the recent market developments, the three core objectives of securities regulation as stated in the IOSCO Objectives and Principles of securities regulation - (i) investor protection, (ii) fairness, efficiency and transparency of markets, (iii) reduction of systemic risk - still hold.
4. The new landscape of financial markets does not require that these general objectives be changed or amended but may require rethinking the ways in which these principles are to be applied to situations that are likely to escape traditional forms of legislation and regulation.
5. Therefore, regulators should strive to: maintain high standards of investor protection and market integrity, consider the economic impact of regulation (cost/benefit analysis),

avoid distortions caused by “inappropriate” regulation (level playing field) and not be an obstacle to financial innovation.

Where do issues for regulators stem from?

We may then ask where do issues for regulators stem from? I will address two main topics:

- A. the blurring of roles, and
- B. the emergence of "transnational markets".

Blurring of roles

6. Exchanges becoming more like brokers in terms of.

- legal structure,
- being “for profit” organisations and therefore having "commercial" functions.

7. Brokers becoming more like exchanges; they are increasingly:

- looking to capture both sides of trade,
- developing automated order routing and matching systems.

8. The regulatory issues, then, are:

- Should "for profit organisations" retain regulatory functions?
- Is the existing regulatory framework adequate to ensure an healthy competition amongst different providers of trading services ?

Exchanges as “for profit organisations”

9. Conflicts of interest are inherent in the management of exchanges and therefore cannot be eliminated. Since exchanges to a certain extent perform regulatory functions, conflicts may arise where the interests of the public conflict with the commercial interests of the exchange owners. However, the intensity of these conflicts of interest may vary according to the different ownership/membership structure that the exchange chooses to adopt.

10. Exchanges typically were and in some cases still are “mutualistic organisations”. The origin of exchanges can be found when a group of intermediaries decide to share the cost of a common trading facility in order to minimise the individual cost of providing investment services.
11. In a non-profit configuration revenues are needed only to cover the expenses and the investment necessary to operate the common trading facility. Therefore in a non-profit environment, the conflicts between the commercial interests of the exchange and the public interest are reduced.
12. When an exchange becomes a for profit organisation, the pressure for profit maximisation may exacerbate some of the inherent conflicts (eg. Listing). The issue is "whether the commercial pressures (and corporate structure) of a for profit entity will undermine the commitment of resources and capabilities of the exchange to effectively fulfil its regulatory and public interest responsibilities".
13. However, if the result of demutualization is that the exchange becomes a real public company, where the ownership is dispersed and, eventually, the exchange itself is listed, some of the conflicts may lessen. In this case, demutualization leads to a separation of the owners of the exchange from its members.
14. If this is the case, ideally the public investing in the exchange is identical to the public which should be protected from the conflicts themselves. Another advantage of listing an exchange is that the exchange becomes subject to the disclosure regime that applies to listed companies.
15. Of course there are also problems with listing an exchange. Firstly, the assumption that investors have the same long term view usually associated with the fulfilment of the public interest objectives is perhaps a heroic one. Investors may not have a sufficiently long term view of the public interest objectives. Secondly, there is a corporate governance problem associated with a dispersed ownership structure: agency costs may hinder an effective monitoring of managers. Last but not least, can the listed exchange regulate itself?
16. It would be at least anomalous if the exchange had to decide about the admission to trading of its own securities and supervise its compliance with the disclosure requirements applicable to listed companies. The solution, in the case of the Australian Stock Exchange, was that ASIC was given the power to administrate the listing rules in relation to the ASX.

17. The issue for regulators is then to identify adequate measures that, according to the different governance structure that an exchange may adopt, allow conflicts of interest to be identified and adequately managed. There are different options available ranging from enhancing the transparency of the exchange to more rigorous regulatory oversight or imposing the separation of the commercial function from the regulatory functions. The latter option might entail simply requesting the exchange to implement adequate "Chinese Walls" or transferring some or all regulatory functions to a different Authority.

Evaluation of potentially "anti competitive" effects of existing regulation

18. The second issue relates to competition amongst different providers of trading services. Since exchanges are becoming similar to other market participants (ie. ATS/ECN) in terms of their legal structure, and the goals and functions they perform, we should ask if the present regulatory framework is adequate to allow a level playing field amongst providers of trading services (i.e. exchanges, ATS and broker/ dealers).

19. In Europe, the approach to the regulation of trading facilities is generally based on the choice between the "regulated markets" regime and the "broker/dealer regime" with a case-by-case evaluation. In Italy, however, the operator of a trading facility which does not provide direct access to retail investors may choose to be regulated as an ATS (Sistema di Scambi Organizzati - SSO). In this case the operator of the system is not subject to licence requirements but it has to notify CONSOB of the rules applying to the system, details of price formation process and financial instruments traded.

20. The approach currently adopted in Europe is the so called "institutional" approach to regulation. According to this approach, the nature of regulatory duties a trading system is required to undertake is typically determined by the regulatory classification assigned to it by the competent authority (or chosen by the operator of the trading system).

21. One may ask whether regulating a trading system as a traditional broker is appropriate since, for example, it subjects trading systems to capital requirements that may not be appropriate for their activities. On the other hand, financial intermediaries are normally subject to record keeping and reporting requirements to the competent authorities for audit trail purposes but they are not subject to

transparency requirements with respect to the transactions executed¹. In this case, when a security is traded both on an ATS and on a regulated market, the ATS may free ride the regulated market as the latter is subject to "costly" transparency requirements.

22. Therefore, under the institutional approach, a new category should be created to take into account of ATSs and the applicable regulatory requirements should be identified.

23. A different approach is the "functional" approach. Under this approach the quantity and quality of regulation imposed on a trading system is solely dependent on the functions it undertakes. (eg., it could be specified that all systems which provide price discovery mechanisms are subject to certain regulatory burdens such as publication of prices and quotes emanating from their systems, independently of the entity that operates the system).

24. Finally, there is what may be called the "separation and competition" approach: issues as the appropriate level of transparency, fragmentation, price discovery and, more generally, the efficiency of market microstructures should not be a concern for securities regulators. According to this view, fair competition among trading systems would be sufficient to deliver the desired regulatory goals and efficiency. Once the market for trading services has been freed from anti-competitive practices, regulators should only focus on issues such as insider trading or price manipulation, the behaviour of market participants and listed companies regulation.

25. Clearly, the latter approach would only be successful in an ideally "efficient market", where investors have the information necessary to choose (and the possibility to access) the most efficient trading system. Unfortunately, this is not the case, as investors, including institutional investors, do not have access to all the relevant information. Therefore, there is still some room for regulatory intervention in order to improve efficiency.

Transnational Markets - Regulatory issues

26. A second set of regulatory issues stem from the emergence of "cross border" or "transnational" markets, in other words trading systems which offer direct access, through electronic links, to participants located in multiple jurisdictions.

¹ Although in some jurisdictions, financial intermediaries must disclose to the public some information on transactions executed off market concerning securities traded on regulated markets.

27. Properly regulated, such systems have the potential to substantially contribute to increasing the efficiency of the market process. However, they also raise a number of fundamental questions as to how regulators in each of the relevant jurisdictions should:
- discharge their individual regulatory responsibilities arising from the operation of the market;
 - ensure that they address any additional regulatory risk that arises from the cross-border nature of the market;
 - promote effective regulation while avoiding unnecessary costs.
28. At present, these questions raise issues - such as the definition of a market's boundaries and the coordination of regulatory responsibilities - on which there is no universal legal or regulatory approach. This situation arises, at least in part, from the fact that most market regulations have been drawn up to address a world in which market operators, market participants and the market themselves were located in the same jurisdiction.
29. To address these issues regulators can consider a variety of approaches which may include some or possibly all of the following:
- coordination of regulatory responsibilities for specific matters;
 - information-sharing arrangement;
 - other cooperation arrangements.
30. The selected approach may vary, depending on such issues as:
- the regulatory approach in each jurisdiction,
 - the nature of the market (for example, the extent of retail investment),
 - the existence of formal linkages between market operators in different jurisdictions.
31. The willingness to coordinate regulation and place reliance on other regulators' standards is likely to be influenced by the standards actually adopted by other regulators. To this extent, IOSCO plays a key role as standard setting body. The implementation of the IOSCO O&P of securities regulation by relevant jurisdictions, is a pre-condition for arrangements among securities regulators for coordination of regulatory and supervisory powers.
32. The more all jurisdictions adopt such standards the more regulators in each jurisdiction will feel comfortable, where they are legally able, to share or even delegate some of their regulatory responsibilities in circumstances where this is likely to provide the most efficient solution.

33. Adequate and effective information-sharing arrangements are also likely to be essential in preventing regulatory 'gaps' in cross-border markets. Information-sharing arrangements of some kind will be needed in any event. But the extent and importance of these arrangements may well grow in instances where relevant regulatory authorities share or delegate regulatory responsibilities to another regulator better placed to undertake a particular regulatory function.

Which structure for securities regulation and surveillance in Europe?

34. The issue of how to further develop cooperation and coordination amongst different regulators in Europe and, more generally, how to develop an efficient and effective structure for securities regulation and surveillance in Europe requires an analysis of the future possible scenarios.

35. In the medium term different exchanges will continue to exist. In the long term there may be the emergence of a network of exchanges or a single exchange.

36. In the medium term, thus, more coordination and harmonisation in the field of financial regulation and supervision is needed. The same holds in the case of the emergence of a network of different exchanges.

37. Notwithstanding the existence of several directives addressing financial disclosure, directives covering public offerings and listings, directives regulating trading markets and financial intermediaries, differences remain in the institutional structure of supervision, the division between regulation and self regulation or between the powers of the securities market regulator and market authorities, as well as problems of enforcement when intermediaries or issuers are located beyond the domestic borders.

38. Minimum harmonisation and mutual recognition provided for the European legislation have not been sufficiently effective to the creation of a real internal market in Europe. There may still be incentives to promote less demanding regulations so as to attract more investment firms and listed companies to operate in the domestic country, when the level of harmonisation is inadequate.

39. Some hold the view that regulatory competition is beneficial and improves the quality of regulation. On the other hand, competition between regulatory regimes runs the risk of reducing rather than improving quality, and it may better serve the interests of the supervised than the public.

40. Where a single exchange emerges like the European exchange, the regulatory and supervisory framework may be different. Presumably, the exchange will be incorporated in a single country and will be supervised and regulated by the local authority. However, the major difference with traditional national exchanges is that in such case the majority of investors, intermediaries and listed companies will be located in jurisdiction different from the jurisdiction in which the market operator is authorised.

41. Therefore, several problems may arise:

- Where and in what language do listed companies have to disclose (price-sensitive and accounting) information? (And, if the exchange is licensed in a jurisdiction not joining the European Monetary Union, in which currency such information will be provided, and in which currency the securities will be traded);
- Who is responsible for insider trading and market manipulation when, for example, a foreign investor acted through a "foreign intermediary" on a "foreign listed companies"?
- How to enforce market rules when intermediaries are located in other jurisdictions?
- How to enforce disclosure rules when the issuers are located in jurisdiction other than the one in which the market operator is licensed?
- How to ensure that foreign investors are provided with adequate information?

42. Given the previous questions an important role would remain for authorities located in jurisdictions other than that in which the exchange has been authorised.

43. This topic goes beyond the supervision of exchanges but is more general: with one currency and a single monetary policy, does it still make sense to deal with domestic regulations? The obvious question is then: does Europe need a single European Regulator? This is a difficult question to answer. There are pro and cons for such a proposal.

44. The main cons of the proposal may be the following:

- Different rules (such as commercial codes, company laws, corporate governance, bankruptcy laws ...) still apply;
- EU Directives, where they exist, are only a common ground;
- Common currency (same monetary policy) but different fiscal policy (tax);
- Excessive concentration of powers in a single regulator (accountability);
- National enforcement would still be needed;
- Finally, the Treaty of Rome should be amended to give the single regulator powers beyond the domestic borders

45. The Pros are:

- Increasing integration among financial markets;
- (Implicit) mergers and other arrangements among stock-exchanges, central depositories and clearing and settlement systems ;
- Dual and cross-border offerings and listings;
- Cross-border mergers among major banks;
- Need of integrated supervision on markets (insider trading, market manipulation, trading halt, Electronic Communication Networks) and intermediaries (conglomerates).
- Need of centralised European Enforcement, since cooperation amongst Authorities is sometimes not sufficiently swift and efficient.

46. A first effort towards a more efficient and effective coordination of the regulatory, surveillance and enforcement activities of the European Securities Commissions was made in December 1997 with the creation of the Forum of European Securities Commissions (FESCO). FESCO brings together the statutory securities commission of the European Economic Area (EEA)². It was set up with the aim to enhance the exchange of information between national securities commissions, to provide the broadest possible mutual assistance to reinforce market surveillance and effective enforcement against abuse, to ensure uniform implementation of EU Directives and to develop common regulatory standards in areas not harmonised by European Directives.

47. One of the most notably achievements of FESCO is the Multilateral Memorandum of Understanding on the surveillance of securities activities and the creation of an integrated surveillance authority, FESCOPOL (February 1999). The objective is to establish "a pan-European regulatory framework to provide the broadest possible mutual assistance between competent authorities of member states of the EEA so as to enhance market surveillance and effective enforcement against financial abuse".

48. Each member is committed to implementing the FESCO standards in its home jurisdiction. However, where the implementation of those standards requires legislative changes in the national legal framework problems may arise since such standards are accepted on a voluntary basis.

49. In the longer term, a solution would be to establish a European System of Financial Supervisors, organised in a similar way to the European System of Central Banks. In each country there will be one national member of the ESFS. The national authority would be responsible for implementing the policy recipes (on stability and

² Austria, Belgium, Denmark, Finland, France, German, Freece, Iceland, Ireland, Italy, Luxembourg, The Netherlands, Norway, Portugal, Spain, Sweden and United Kingdom

transparency) agreed upon at Euro level. It will directly conduct inspections and decide sanctions and penalties. This approach would also strengthen the coordination between securities regulators and the ECB.

50.As in a prehistoric world, the landscape of European Financial Markets is still evolving and has not yet reached a stable configuration. New continents will emerge, new forms of life will appear while others will not survive. How the institutional framework will look like in the next years is still an open question.

END

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