STRENGTHENING CAPITAL MARKETS AGAINST FINANCIAL FRAUD

TECHNICAL COMMITTEE
OF THE
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

FEBRUARY 2005

EXECUTIVE SUMMARY

Over the past several years, a series of very high-profile financial scandals involving large publicly-traded companies appeared to create doubts in the minds of investors throughout the world about the integrity of global capital markets. While, at first, the largest of these scandals seemed limited to the United States, more recent events — including the December 2003 discovery of financial improprieties at Parmalat S.p.A. in Italy followed by other scandals in various jurisdictions — demonstrated that this phenomenon was not peculiar to any one market and the concerns raised by these financial scandals were truly global in nature. Members of the Technical Committee of the International Organization of Securities Commissions recognize that these investor doubts must be answered if financial stability and economic prosperity are to be maintained. Consequently, the Technical Committee formed a Task Force of Chairmen charged with investigating the issues uncovered by these financial scandals and identifying any broad trends. It was also tasked with making recommendations about the enhancements securities regulators should undertake to ensure that the current regulatory framework remains robust and serves to protect the integrity of global capital markets, restore investor confidence, and combat financial fraud, notwithstanding significant changes in the marketplace.

Regulatory Principles and Standards

The following report is a result of this work. It identifies seven separate areas that have figured prominently in many recent high-profile financial scandals:

1) Corporate governance, including the role of independent directors on an issuer's corporate board, the protection of minority shareholders, the importance of independent auditor oversight committees, and mechanisms to protect against conflicts of interest presented by related-party transactions;

2) Auditors and audit standards, including auditor independence, the effectiveness of audit standards and auditor oversight, and issues related to mandatory auditor rotation;

3) Issuer disclosure requirements, including management's discussion and analysis of material events and factors likely to have an impact on the issuer;

4) Bond market regulation and transparency, including the types of financial disclosures required of bond issuers and the transparency of bond market price-setting mechanisms;

5) The role and obligations of market intermediaries, whether they contributed to recent financial scandals, and how these entities can mitigate reputational, legal and operational risk through adequate controls and procedures, and ensure that material non-public information they acquire about an issuer is not misused;

6) The use of complex corporate structures and special purpose entities, and the circumstances where they may pose particular regulatory issues; and,

7) The role of private-sector information analysts, and the ways in which such individuals and entities can protect their analytical integrity and independence.

For each of these seven areas, the Report discusses what issues recent financial scandals have raised, and whether any international standards or principles currently exist to remedy or address the issues identified. The Report then describes a series of action items for further work by the Technical Committee, including the development of new principles or standards where necessary, further fact-finding work to identify if regulatory weaknesses in a certain area exist, and cooperation with other international organizations to advance projects undertaken by them that the Technical Committee believes may address some of the issues it has identified.

Examples of priority projects that the Technical Committee has decided to undertake in the near future to address regulatory weaknesses identified in the Report include such things as:

- Prioritizing ongoing Technical Committee work to uncover any trends that may exist with regard to recent audit failures indicating one or more problematic areas in current audit standards; and,

- Reviewing the role played by intermediaries in recent financial scandals, determining whether that role contributed to the financial scandals and, if so, developing a set of principles for intermediary policies and procedures (including internal controls) concerning their financial transactions.

Implementation and Enforcement

The Report also covers two overarching issues — implementation of international standards and principles, and cross-border enforcement cooperation — separately. Implementation is, of course, a *sine qua non* with regard to the effectiveness of any set of principles or standards. And, in modern capital markets, where capital flows easily across national borders, cross-border enforcement cooperation perhaps is the single most powerful tool securities regulators and law enforcement authorities have at their disposal to prevent, deter, detect and prosecute cross-border financial fraud.

In the process of reviewing the key regulatory issues highlighted by these recent financial scandals, the Technical Committee determined that, in many cases, regulatory principles or standards designed to address the weaknesses identified in this Report have already been developed. In other words, the Technical Committee is of the view that, in very many cases, there already is a widespread consensus about what regulatory problems exist and how these problems can be solved. However, it is not now known whether implementation of these principles and standards is universal among securities regulators. Where implementation is not universal, the Technical Committee believes a lack of implementation may lead to potential regulatory "gaps" given the cross-border operations of many participants in modern capital markets. Further, the increasingly global nature of modern capital markets means that, even if implementation of international regulatory principles and standards were universal, the benefits of these principles and standards could be defeated if financial regulators and law enforcement agencies lack the ability to take effective enforcement action, to share enforcement-related information, and coordinate investigations.

Accordingly, the Technical Committee has identified two operational priorities: (1) promoting implementation of the international standards and principles already developed: and, (2) facilitating cross-border enforcement cooperation so that existing securities laws and regulations can be fully enforced. To accomplish these objectives, the Technical Committee has adopted the following three policies:

1) Emphasizing implementation of all existing regulatory standards and principles among IOSCO members, using implementation assessment surveys, setting implementation benchmarks, and making implementation of IOSCO principles and standards a cornerstone of IOSCO's technical assistance program;

2) Confirmation of the IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (IOSCO Multilateral MOU) as the benchmark for enforcement cooperation among IOSCO members, with the goal of eventually making the ability to sign on to the IOSCO Multilateral MOU a primary benchmark for continued IOSCO membership, particularly for historically uncooperative jurisdictions; and

3) Prioritization, using market size, transactional flows and importance to the global financial system as criteria, of those under-regulated and uncooperative jurisdictions that are most problematic for cross-border enforcement and development of a workplan on how these jurisdictions can best be encouraged to improve their regulatory oversight and abilities to cooperate with cross-border enforcement investigations, using the IOSCO Multilateral MOU as the benchmark against which cooperation will be assessed.

In conclusion, the Technical Committee notes that even the highest-quality regulatory standards, fully implemented and enforced, cannot eliminate financial fraud. Financial fraud hurts investors and damages the integrity of our markets. It takes the constant vigilance of all stakeholders — issuers, investors, auditors, analysts, market operators, market intermediaries, regulators and other enforcement agencies — to minimize such market misconduct. IOSCO is committed to working with all parties to better protect the integrity of global capital markets. Through active cooperation and the implementation of IOSCO standards, the Technical Committee believes that the work it has decided to undertake will significantly strengthen global capital markets by making financial fraud much more difficult to accomplish, and more easily detected and less damaging to investors when it occurs. A timetable for certain priority Technical Committee projects designed to address issues outlined in the Report is attached to this Executive Summary, along with a complete summary of the Report's proposals.

TECHNICAL COMMITTEE PRIORITY ITEM ACTION PLAN TO STRENGTHEN CAPITAL MARKETS AGAINST FINANCIAL FRAUD

A. PRIORITY WORK RELATING TO NEW REGULATORY PRINCIPLES AND STANDARDS

Objective	Priority Deliverable	Proposed Timeline
1. Work jointly with the Organization for Economic Cooperation and Development to undertake additional analyses of the definition and role of independent directors on the boards of issuers and the additional protections required in situations where issuers are controlled by a dominant shareholder.	Joint OECD-IOSCO Work	Mid-2006, pending agreement with the OECD
2 Work jointly with the OECD to undertake a fact-finding study regarding how corporate governance rules and principles are enforced in IOSCO and OECD jurisdictions.	Joint OECD-IOSCO Work	Mid-2006, pending agreement with the OECD
3. Uncover any trends that may exist with regard to recent audit failures indicating one or more problematic areas in current audit standards.	Report on trends regarding recent audit failures	End 2006
4. Undertake study of issuer internal control requirements in Technical Committee jurisdictions.	Fact-finding Report	Late 2005-Early 2006
5. Develop mechanisms and best practices for implementing the recommendations contained in the Technical Committee's report on "Transparency in Corporate Bond Markets."	Report on best practices for improving bond market transparency	End 2006
6. Determine whether current consideration of principles for public debt issuance disclosure should be reconsidered in light of recent financial scandals involving publicly	Technical Committee to reconsider current approach to developing debt issuance disclosure principles	By October 2005

traded debt securities, and whether debt disclosure standards should include disclosures of related-party transactions and management's discussion of financial position and results of operations.	Completion of IOSCO Debt Issuance Disclosure Principles	October 2005
7. Review role played by market intermediaries in recent financial scandals, determine whether that role contributed to the financial scandals and, develop set of principles for intermediary policies and procedures (including internal controls) concerning their financial transactions.	Review of issues and possible development of principles	Initiate by March 2005; Progress Report by October 2005; Development of principles (if necessary) by mid-2006

B. Priority Work Relating to Implementation

Objective	Priority Deliverable	Proposed Timeline
1. Emphasize implementation of all existing regulatory standards and principles among IOSCO members.	Adoption of IOSCO Strategic Plan	April 2005
	Completion of current self-assessments of implementation of the *IOSCO Objectives and Principles of Securities Regulation* (IOSCO Core Principles) and design new program for additional jurisdictions designated for assisted self-assessment	End 2005
	Continue working closely with the International Financial Institutions to help assessment of compliance with IOSCO Core Principles and strengthen funding to assist IOSCO members improve their capacity to implement IOSCO Core Principles	Ongoing, completion by End 2005

C. PRIORITY WORK RELATING TO CROSS-BORDER ENFORCEMENT COOPERATION

Objective	Deliverable	Proposed Timeline
1. Confirmation of the IOSCO Multilateral MOU as the clear benchmark for enforcement cooperation among IOSCO members, with the goal of eventually making the ability to sign on to the Multilateral MOU a primary benchmark for continued IOSCO membership, particularly for historically uncooperative jurisdictions.	Presidents' Committee Resolution to be tabled at IOSCO Annual Meeting, Colombo	April 2005
2. Prioritization, using market size, transactional flows and importance to the global financial system as criteria, of those under-regulated and uncooperative jurisdictions that are most problematic for cross-border enforcement and development of a workplan on how these jurisdictions can best be encouraged to improve their regulatory oversight and abilities to cooperate with cross-border enforcement investigations.	Technical Committee prioritization of under-regulated and uncooperative jurisdictions and development of workplan Dialogue with select Offshore Financial Centers (OFCs)/under-regulated and uncooperative jurisdictions to encourage improved enforcement cooperation	Completed, February 2005 Dialogue started February 2005
3. Assessment of non-cooperative jurisdictions and analysis aimed at checking whether OFCs have in place legislation that is adequate to ensure that information is collected and shared among supervisory authorities in a cooperative and non-discriminatory manner	Assessment as a result of dialogue with OFCs/ under-regulated and uncooperative jurisdictions	Dialogue started February 2005

List of Proposed Technical Committee Actions to Strengthen Capital Markets Against Financial Fraud

The Technical Committee has agreed to take the following actions:

- Request that the OECD, jointly with IOSCO, undertake additional descriptive, thematic analyses of the definition and role of independent directors on the boards of issuers and the additional protections required in situations where issuers are controlled by a dominant shareholder.

- Request that the OECD, jointly with IOSCO, undertake a fact-finding study regarding how corporate governance rules and principles are enforced in IOSCO and OECD jurisdictions.

- Undertake follow-up work to the implementation survey of the IOSCO Auditor Oversight Principles in order to accelerate implementation where implementation is shown to be incomplete.

- Prioritize ongoing Technical Committee work to uncover any trends that may exist with regard to recent audit failures indicating one or more problematic areas in current audit standards.

- Explore through coordinated work with public audit oversight boards whether auditor verification approaches allowed under current audit standards are easily circumvented by those intent on committing financial fraud.

- Undertake through coordinated work with public audit oversight boards a fact-finding study to determine whether auditors have basic measures in place to help safeguard against complicity in a financial fraud by their own employees or local branch managers.

- Undertake coordinated work with public audit oversight boards to determine whether ways exist to enhance regulatory cooperation in the area of auditor oversight that can diminish risks posed by multiple auditors.

- Undertake a study of Technical Committee members regarding internal control requirements for issuers.

- Review the Technical Committee's recent report, "Transparency in Corporate Bond Markets" to determine how to improve the transparency of bond market trading and whether, in light of recent financial scandals, additional recommendations are necessary.

- Develop mechanisms and best practices for implementing the recommendations contained in the IOSCO report "Transparency in Corporate Bond Markets".

- Determine whether the Technical Committee's revised approach to public debt issuance disclosure should be reconsidered in light of recent financial scandals involving publicly traded debt securities, including whether debt disclosure standards should include disclosures of related-party transactions and management's discussion of financial position and results of operations.

- Review the role played by intermediaries in recent financial scandals, determine whether that role contributed to the financial scandals and, if so, develop a set of principles for intermediary policies and procedures (including internal controls) concerning their financial transactions. Such principles will address such issues as the general nature of the policies and procedures intermediaries should use or have in place to mitigate reputational, legal and operational risks, approve new financial products and help ensure that these institutions are not conduits for fraudulent transactions or market manipulation schemes.

- In light of current Technical Committee work on the subject, determine whether the use of Special Purpose Entities warrants additional disclosure in an issuer's non-financial statement disclosures.

- Conduct an analysis of whether OFCs have in place legislation that is adequate to ensure that information is collected and shared among supervisory authorities in a cooperative and non-discriminatory manner, using the IOSCO Multilateral MOU as the benchmark for enforcement cooperation.

- Encourage the IOSCO Presidents' Committee to adopt the IOSCO Multilateral MOU as a clear benchmark for enforcement cooperation among IOSCO members with the goal of eventually making the ability to sign on to the Multilateral MOU a primary benchmark for continued IOSCO membership, particularly for historically uncooperative jurisdictions.

- Prioritize, using market size and importance to the global financial system as criteria, those under-regulated and uncooperative jurisdictions that are most problematic for cross-border enforcement and develop a workplan on how these jurisdictions can best be encouraged to improve their regulatory oversight and abilities to cooperate with cross-border enforcement investigations.

I. BACKGROUND TO THE FORMATION OF THE TASK FORCE

Over the past several years, the International Organization of Securities Commissions has undertaken a number of substantive projects designed to improve securities market regulation and enforcement cooperation among its members. These projects have included principles regarding securities market regulation generally,[1] as well as regulatory principles for areas such as auditor oversight,[2] auditor independence,[3] ongoing disclosure and reporting material developments,[4] non-financial statement disclosure,[5] securities analyst conflicts of interest,[6] and the activities of credit rating agencies.[7] IOSCO has also conducted substantial work on mechanisms designed to improve cooperation and information-sharing among securities regulators investigating and prosecuting violations of securities laws and regulations, including the development of the IOSCO Multilateral Memorandum of Understanding[8] with an accompanying accession review process that has already succeeded in encouraging a number of jurisdictions to enact laws permitting their securities regulators to share information and cooperate with the regulators' foreign counterparts. Each of these principles as well as the Multilateral MOU was designed to address recognized vulnerabilities that posed threats to the integrity and stability of global capital markets.

Recent high-profile, global financial and securities scandals have underscored for IOSCO that an additional review of these and other areas may be necessary. In response to these scandals, during its meeting in February 2004, IOSCO's Technical Committee commissioned a high-level Chairmen's Task Force to review the circumstances giving rise to the Parmalat matter (which, at that time, had recently become public), and other recent financial scandals, including Enron, Worldcom, Vivendi, Royal Dutch Shell, Hollinger, Tyco and Royal Ahold. In some of these cases, fraud has been alleged. This Task Force was charged with assessing what implications these matters hold for the stability and integrity of global capital markets, and suggesting

---

[1] "Objectives and Principles of Securities Regulation," (1998, updated October 2003). This document can be downloaded from IOSCO's On-Line Library at www.iosco.org (IOSCOPD154).

[2] "Principles for Auditor Oversight," (October 2002). This document can be downloaded from IOSCO's On-Line Library at www.iosco.org (IOSCOPD134).

[3] "Principles of Auditor Independence and the Role of Corporate Governance in Monitoring an Auditor's Independence," (October 2002). This document can be downloaded from IOSCO's On-Line Library at www.iosco.org (IOSCOPD133).

[4] "Principles for Ongoing Disclosure and Material Development Reporting by Listed Entities," (October 2002). This document can be downloaded from IOSCO's On-Line Library at www.iosco.org (IOSCOPD132).

[5] "General Principles Regarding Disclosure of Management's Discussion and Analysis of Financial Conditions and Results of Operations," (February 2003). This document can be downloaded from IOSCO's On-Line Library at www.iosco.org (IOSCOPD141).

[6] "IOSCO Statement of Principles for Addressing Sell-Side Securities Analyst Conflicts of Interest," (October 2003). This document can be downloaded from IOSCO's On-Line Library at www.iosco.org (IOSCOPD150).

[7] "IOSCO Statement of Principles Regarding the Activities of Credit Rating Agencies," (October 2003). This document can be downloaded from IOSCO's On-Line Library at www.iosco.org (IOSCOPD151).

[8] IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information, (May 2002). This document can be downloaded from IOSCO's On-Line Library at www.iosco.org (IOSCOPD126).

avenues for further Technical Committee work. This Task Force was chaired by the Italian Commissione Nazionale per le Società e la Borsa (Consob) and the US Securities and Exchange Commission (US SEC) and included the chairmen and senior policy makers of the Australian Securities and Investments Commission (Australia), the Comissão de Valores Mobiliários (Brazil), the Autorité des marchés financiers (France), the Bundesanstalt für Finanzdienstleistungsaufsicht (Germany), the Securities and Futures Commission (Hong Kong), the Financial Services Agency (Japan), the Comisión Nacional Bancaria y de Valores (Mexico), the Netherlands Authority for the Financial Markets (Netherlands), the Ontario Securities Commission (Ontario, Canada), the Comissão do Mercado de Valores Mobiliários (Portugal), the Autorité des marchés financiers (Quebec, Canada), the Comisión Nacional del Mercado de Valores (Spain), the Capital Markets Board (Turkey), the Financial Services Authority (United Kingdom), and the Commodity Futures Trading Commission (United States).

The work of the Technical Committee has resulted in two reports. The first covers the facts of the Parmalat matter. This second report represents an analysis of issues that have been raised as a result of recent financial scandals that merit attention by the IOSCO Technical Committee. In Section II, the Report highlights a number of key regulatory issues that the available information indicates securities regulators will wish to consider or reconsider in developing or reinforcing the regulation of capital markets. Section II also discusses whether and how these issues are currently addressed by existing IOSCO principles and standards, or whether they are essentially issues of first impression for the Technical Committee. Section III then discusses the importance of fully and effectively implementing relevant international regulatory principles and standards. Finally, Section IV takes up the issue of cross-border enforcement cooperation and the role it plays in strengthening global capital markets against fraud, how cross-border enforcement cooperation can be strengthened among IOSCO members, and special cross-border enforcement issues that may arise where under-regulated and uncooperative jurisdictions are involved.

II. DISCUSSION OF KEY REGULATORY ISSUES IN LIGHT OF RECENT FINANCIAL SCANDALS

The outline of events leading up to the recent financial scandals about which a great deal has been published, highlights a number of issues that securities regulators will wish to consider when analyzing current regulatory approaches. Some of these issues are relatively new, and have not been thoroughly studied by the IOSCO Technical Committee or its standing committees in the past.[9] Many others, however, are not new and have been addressed to varying degrees by IOSCO principles or standards and their implementation.

As a general matter, the issues raised by recent financial scandals fall into several broad categories, which are discussed in greater detail below. These broad areas include:

A. Corporate governance, including the role of independent directors on an issuer's corporate board, the protection of minority shareholders, the importance of independent board auditor oversight committees, and mechanisms to protect against conflicts of interest presented by related-party transactions;

B. Issues relating to auditors and audit standards, including auditor independence, the effectiveness of audit standards and auditor oversight, and issues related to mandatory auditor rotation;

C. The effectiveness of financial and non-financial statement disclosures, including management discussion and analysis of material events and factors likely to impact the issuer;

D. The transparency and regulation of corporate bond markets, including the types of financial disclosures required of bond issuers and the transparency of bond market price-setting mechanisms;

E. The role and obligations of market intermediaries, including the obligations underwriters and other intermediaries have to investors and methods by which these entities can mitigate reputational, legal and operational risk through adequate controls and procedures and ensure that material non-public information they acquire about an issuer is not misused;

---

[9] IOSCO's Technical Committee has five permanent Standing Committees:

Standing Committee 1 on Multinational Disclosure and Accounting, which considers regulatory matters that touch on the disclosure and accounting standards required of the issuers of publicly sold securities;

Standing Committee 2 on the Regulation of Secondary Markets, which considers cross-border regulation of how stock markets and exchanges operate;

Standing Committee 3 on the Regulation of Market Intermediaries, which considers cross-border regulatory matters regarding the oversight of market intermediaries such as broker-dealers and underwriters;

Standing Committee 4 on Enforcement and Exchange of Information, which considers ways to improve cross-border enforcement cooperation among securities regulators; and,

Standing Committee 5 on Investment Management, which studies cross-border regulatory matters that pertain to collective investment schemes and their investment advisers.

F. The use of complex corporate structures, including complex financial and shareholding structures and the use of special purpose accounting entities, and the circumstances where their use may pose particular regulatory issues;

G. The role of private-sector information analysts, and ways by which such individuals and entities can protect their analytical integrity and independence.

The issue of enforcement cooperation — perhaps the single most significant tool that securities regulators can use to prevent, deter, detect and prosecute cross-border financial fraud — is dealt with separately, in Section IV of this Report. The implementation of international regulatory principles and standards, which is, of course, a *sine qua non* with regard to their effectiveness, also is discussed separately, under Section III.

A. Corporate Governance

1. Issues

Corporate governance is a term used to describe a system of overlapping legal, regulatory, organizational, and contractual mechanisms designed to protect the interests of a company's owners (the shareholders) and limit opportunistic behavior by corporate managers who control the company's operations. Many public corporations have diffuse ownership structures whereby no single individual or investor actually owns enough shares of the company to actually control it or single-handedly place representatives on the issuer's board of directors. In such situations, corporate governance mechanisms, ideally, should protect the interests of all investors against corporate managers whose own interest may not necessarily coincide with those of the company's shareholders.

In some circumstances, however, a controlling shareholder may also exercise management control over the company. Under such conditions, the traditional fear is less that the interests of management and shareholders diverge than it is that controlling shareholders may direct the company in ways that exploit minority shareholders. Rather than acting merely as a check against opportunistic behavior by management, strong corporate governance mechanisms — independent audit committees, board approval requirements for related-party transactions, legal protections for minority shareholders, and others — also protect the rights of minority shareholders against possible abuses by controlling shareholders. Many jurisdictions impose a legal obligation or fiduciary duty on corporate directors to always act in the best interests of *all* shareholders, not just those with a majority interest.

Media reports following recent scandals often focus on the breakdown of corporate governance structures. In particular, the corporate governance issues highlighted by these cases of corporate crises frequently concern the following aspects:

- *The independence of members of the issuer's board of directors,* to help protect the interests of shareholders, who own the issuer, against the interests of management, who control its day-to-day operations;

- *Controls designed to protect against abusive related-party transactions*, where issuer assets might be used to benefit senior managers or controlling shareholders; and,

- *Legal protections for shareholders (particularly minority shareholders),* to protect them against possible abuses by controlling shareholders and managers.

Other elements relating to corporate governance — including extensive public financial and non-financial statement disclosure requirements, and the importance of independent audit committees within an issuer's board of directors — are discussed more fully in separate sections.

a) *Board Independence*

A board of directors of a publicly traded company is the first, best line of defense protecting shareholder interests. However, in many of the recent financial scandals there have been suggestions that the boards of directors of the companies involved lacked any real independence from management. Traditionally, a board's close alignment with top management has been considered problematic, as it leads to weak oversight of management and the potential for managerial "opportunism" (i.e., management using corporate assets to benefit themselves rather than the corporation).[10]

However, since one of the roles of a company's board is to guard the interests of shareholders against opportunistic behavior by management, issues relating to board alignment with management are more complicated where management and the majority shareholder are one and the same. In this case, majority shareholders have an incentive to oversee the company's performance very closely, due to the fact that they may be so heavily invested in an issuer, with fewer options for divesting themselves (if for no other reason than professional pride).

Nevertheless, there is also the risk that majority shareholders (especially if they own significantly less than 100 percent of the company's capital) can use strategies which do not maximize value for shareholders, but have the aim of obtaining the highest possible level of private benefits from the company. In this case, the presence of strong, independent directors may have the effect of discouraging such behavior, by allowing minority shareholders to monitor how management and the majority shareholder use corporate assets. Although otherwise well-run corporations are not immune to making poor business judgments, justifying significant business decisions to an independent board of directors provides one additional check on the wisdom of the undertaking.

In this regard, recent academic research suggests that direct management of an issuer by "founding family" majority shareholders tends to result in higher-than-average corporate performance.[11] Nonetheless, recent research also suggests that board independence plays a critical role in the success of a family-controlled issuer.[12] One reason suggested for this is that a

[10] Adolf A. Berle and Gardiner C. Means, The Modern Corporation and Private Property, 9, 113, et al. (Harcourt, Brace &World, 1932).

[11] Anderson, Ronald C. & Reeb, David M. (2003), "Founding-Family Ownership and Firm Performance: Evidence from the S&P 500." The Journal of Finance 58 (3), 1301-1327.

[12] Anderson and Reeb (2004), "Board Composition: Balancing Family Influence in S&P 500 Firms," Administrative Sciences Quarterly 49, 209-237. According to this research, based on US public issuers, family-run public

family investor with a long-term stake in the company's performance is combined with a board of directors that acts as a check against family managers using the corporation's assets as their own.[13]

b) Related-party transactions

Several recent financial scandals have involved transactions where corporate funds were used to purchase assets from entities controlled by managers or controlling shareholders at what now appear to be considerably inflated prices, or else caused the issuer to sell assets to managers or controlling shareholders at a considerable discount. In many cases, these "related-party transactions" have been described as corporate "looting" to benefit a small number of individuals at the expense of the company's investors.

The risk of asset-diverting behavior on the part of insiders is particularly acute where the company is part of a complex group structure. In this situation, economic and financial transactions with other companies of the group can be carried out in order to transfer assets from the company to other entities in which insiders have a stronger interest.

There are a variety of mechanisms that exist that can help mitigate the conflicts of interest dangers presented by related-party transactions. Many jurisdictions (and many more corporate bylaws) require significant related-party transactions to be approved by the issuer's board of directors. In some cases, these transactions can only be approved by a majority vote of the board's independent directors, or else require a supermajority vote of all directors. In addition, the securities regulations of many jurisdictions also often require significant related-party transactions to be disclosed in the issuer's non-financial statement disclosures, so that investors can properly evaluate whether corporate assets are being properly used. However, the inherent lack of transparency in these transactions raises questions regarding effective enforcement of these requirements.

As discussed above, independent boards can help safeguard against abusive related-party transactions, where such transactions are required to be approved by the board of directors.

c) Legal protections for shareholders (including minority shareholders)

Recent corporate crises have shown that all types of shareholders are subject to the risk that their investment in the firm is expropriated by those who control the issuer's corporate operations. In corporations with a dominant shareholder or group of shareholders, minority shareholders may be at a disadvantage because the dominant shareholders are in a position to exercise control over

---

corporations with weak boards of directors tend to perform poorly. By contrast, controlled issuers with strong, independent directors on their boards (even if the majority of directors are not independent) achieve better-than-average performance. Anderson and Reeb conclude that strong independent directors are necessary to counterbalance potential opportunism on the part of controlling families and are vital to protecting the rights of minority shareholders.

[13] Id. This research is limited to Standard & Poor's 500 companies in the United States and it is at the moment unclear whether empirical data in other markets with different legal structures and traditions supports this conclusion.

the company's operations and business strategy. While majority shareholders share with minority shareholders an interest in maintaining the viability of the corporation, the controlling shareholder is also in a position to expropriate the investment made by the minority.[14] Under certain circumstances, a majority shareholder may benefit even if the issuer is rendered insolvent, if the assets the controlling shareholder can divert to its own uses exceed its investment in the company.

Most jurisdictions counter this problem through corporate governance laws prohibiting such activity generally and charging a company's board of directors with protecting the rights of all shareholders. In most jurisdictions, majority shareholders or managers who direct a company's assets to their own uses can be sued by minority shareholders or even brought up on criminal charges.

Other protections for minority shareholders often take the form of voting requirements on certain defined issues or the right to select a certain percentage of board members. These requirements or rights may be mandated by legislation, or contained within an issuer's bylaws and articles of incorporation. In some cases, stock exchange listing requirements mandate that an issuer's bylaws and articles contain specific minority shareholder protection provisions. In a few jurisdictions, specific protections may not be mandated by law, but may be contained in a set of best practice guidelines encouraged by a jurisdiction's regulators.

2. Existing Standards and Principles

In some jurisdictions, corporate governance is not an area regulated or overseen by securities regulators.[15] Consequently, IOSCO itself has never undertaken a project to codify a broad set of principles or best practices regarding corporate governance. Nonetheless, a number of international multilateral entities and private organizations have drafted or are in the process of developing best practice guidelines and principles for corporate governance. The most significant of these may be the Organization for Economic Cooperation and Development's (OECD) Principles for Corporate Governance, which were published in 1999 and were revised in 2004 in light of recent corporate governance initiatives.[16] Corporate governance standards are expected to be used in the World Bank and International Monetary Fund's Financial Sector Assessment Program (FSAP) reviews of the financial strengths and weaknesses of assessed jurisdictions. The European Union is also in the process of developing EU-wide corporate governance standards.[17]

---

[14] Id.

[15] In the United States, for example, corporate governance, broadly speaking, remains the domain of state law, despite stock exchange listing requirements regarding corporate governance structures and federal corporate governance mandates included the Sarbanes-Oxley Act of 2002.

[16] "OECD Principles of Corporate Governance," (Organization for Economic Cooperation and Development, 2004). A copy of this document can be accessed from the OECD's website at: http://www.oecd.org/dataoecd/32/18/31557724.pdf.

[17] Communication of the EU Commission COM(2003)284(01), "Modernising Corporate Governance and Enhancing Corporate Governance in the EU – A Plan to Move Forward."

Some jurisdictions currently require many, though not necessarily all, of the numerous recommendations contained in the OECD and other corporate governance guidelines, principles and best practices.

Board independence is addressed by the OECD Corporate Governance Principles in its annotations to Principle VI.E.1. The OECD Principles focus heavily on the duties directors owe shareholders, and emphasize that the board has an obligation to exercise independent judgment on matters brought before it, regardless of individual directors' independence from management, but also advise that:

> *Boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgment to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are ensuring the integrity of financial and non-financial reporting, the review of related party transactions, nomination of board members and key executives, and board remuneration.* [OECD Corporate Governance Principle VI.E.1]

One issue not discussed by the OECD is the difficulty of identifying which directors are actually "independent" and how "independent judgment" can be assured, particularly in situations where ties between corporate officers or majority shareholders and individual directors are not formal. Because different jurisdictions approach the issue of "independence" differently, the OECD Principles eschew defining "independence," other than recommending that some board functions be carried out by committees comprised of a "sufficient number" of non-management directors. Similarly, because jurisdictions differ regarding whether these board committees should include a majority of non-management directors, the term "sufficient number" is not defined. Nonetheless, several recent financial scandals involved boards that lacked independence or were comprised of directors who appeared nominally "independent" or who were independent according to certain listing standards, but whose *de facto* independence from management and/or a controlling shareholder subsequently has been questioned. Consequently, future useful work may define what constitutes a "sufficient number" of directors on a board and what "independent judgment" means in practice.

The OECD Principles more directly address the dangers posed by *related-party transactions*. OECD Corporate Governance Principle V.A.5 states that related-party transactions should be publicly disclosed; while Principle VI.D.6 states that the issuer's board has an obligation to monitor and manage potential conflicts of interest arising out of the misuse of corporate assets and the abuse in related-party transactions. As described above, Principle VI.E.1 also recommends that board committees charged with reviewing related-party transactions should include a "sufficient number" of independent directors.

Finally, the OECD Corporate Governance Principles also address the *protection of minority shareholders*, stating:

> *Minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders acting either directly or indirectly, and should have effective means of redress.* [OECD Corporate Governance Principle III.A.2.]

The annotations to the OECD Corporate Governance Principles note that what constitutes "effective redress" is hard to define and will vary according to different jurisdictions' legal structures and regulatory frameworks. One basic principle in this regard is a legal duty of loyalty owed by the board of directors to *all* shareholders. However, the OECD Principles also note that such a duty is often not sufficient:

> *Other common provisions to protect minority shareholders, which have proven effective, include pre-emptive rights in relation to share issues, qualified majorities for certain shareholder decisions and the possibility to use cumulative voting in electing members of the board. Under certain circumstances, some jurisdictions require or permit controlling shareholders to buy-out the remaining shareholders at a share-price that is established through an independent appraisal. This is particularly important when controlling shareholders decide to de-list an enterprise. Other means of improving minority shareholder rights include derivative and class action law suits.* [Annotations to OECD Corporate Governance Principle III.A.2, page 42.]

The annotations also discuss how independent board members can help protect minority shareholders in situations where an issuer is controlled by a family or dominant shareholder. As a practical matter, requiring board independence where a dominant shareholder exists has been considered problematic, as traditional concerns regarding management oversight do not exist and dominant shareholders are assumed to share with minority shareholders many of the same concerns regarding the issuer's performance. Rather than tackling the matter through independent board members, many jurisdictions address potential conflicts between dominant and minority shareholder separately, through laws designed to protect the interests of minority shareholders.

3. Technical Committee Action Items

The OECD Corporate Governance Principles address many of the corporate governance concerns raised by recent financial scandals — particularly in the areas of board independence, related-party transactions, and the protection of minority shareholders. However, because the OECD Principles are drafted at a high level so they may apply in jurisdictions with varying legal and regulatory frameworks, additional work regarding how to implement the OECD Principles in practice may be useful. Given its expertise in setting issuer disclosure standards and its experience in setting principles for board audit oversight committees, the Technical Committee may be in a position to provide assistance and advice in developing implementation methodologies and implementation assistance regarding the OECD Principles. Likewise, the IOSCO Technical Committee may consider where IOSCO principles, standards and assessment methodologies should be modified.

Accordingly, the Technical Committee will:

- Request that the OECD, jointly with IOSCO, undertake additional descriptive, thematic analyses of the definition and role of independent directors on the boards of issuers and the additional protections required in situations where issuers are controlled by a dominant shareholder;

- Request that the OECD, jointly with IOSCO, undertake a fact-finding study regarding how corporate governance rules and principles are enforced in IOSCO and OECD jurisdictions.

B. Issues Relating to Auditors and Audit Standards

1. Issues

Outside auditors, required by the securities laws and regulations of most jurisdictions, are tasked with confirming for investors that the financial statements disclosed by a public issuer present an accurate and fair accounting of the company's financial condition in all material respects, containing neither "sins of commission or omission" with regard to the use of accounting standards required in the relevant jurisdiction. Audit firms are quick to point out that, while one of their tasks is to detect possible fraud, a "normal" audit of an issuer's financial statements is not a forensic audit of the kind necessary to detect deliberate, elaborate financial fraud. Nonetheless, public auditors are charged with more than merely confirming that an issuer's financial statements are free from accidental, unintentional errors. A robust set of audit standards, even accepting the auditor's limitations in discovering deliberate, elaborate financial fraud, should guide an auditor to detect simpler types of fraud and financial shortcomings by, for example, requiring that the auditor independently confirm the existence of significant bank accounts, verify support for sizable capital and inventory reserves, etc. Such audit standards should include requirements for adequate safeguards to prevent these independent confirmations and other evidential tests from being easily circumvented.

When a financial scandal involving an audit failure occurs, typically one or more of the following has occurred:

1) Outright fraud on the part of corporate managers, elaborate enough to deceive the best efforts of the public auditors to check the accuracy of issuer's financial statements;

2) Outright fraud on the part of audit firm partners/managers in conjunction with corporate managers, which would have been detected by one or more of the auditors but for the complicity of one or more individuals working for one or more of the audit firms or the audit firm itself;

3) Malpractice or negligence on the part of the public auditors, in violation of the relevant generally accepted auditing standards; or

4) Performance on the part of the public auditors that conforms to auditing standards, but where the relevant generally accepted auditing standards were insufficient to guide the auditors in the task of detecting the financial discrepancies.

The issues raised by each of these possibilities overlap to some extent, although in some cases they remain distinct. Among the issues raised with respect to auditors and audit standards and discussed in more detail below are:

- *Oversight of audit firms*, and whether current oversight mechanisms are sufficient to promote high quality, independence and integrity in the audit process;

- *Board audit committees or shareholders meetings*, and their role in hiring independent auditors and overseeing that audit process;

- *The effectiveness of current audit standards*, and whether they are up to the task of guiding auditors in detecting possible financial fraud and the kinds of fraud they reasonably should be expected to detect;

- *Auditor rotation* and whether it can help prevent auditor complicity in a fraud or lower the chances that auditor malpractice or negligence will continue unnoticed;

- *Multiple auditors for issuers with cross-border operations* and how any problems multiple auditors raise can best be mitigated; and,

- *Consolidation in the audit industry* and whether this increases the risks of poor quality audits.

a) Auditor Oversight

Auditor oversight – whether through a regulatory body or some other process — is a necessary external check on the quality and integrity of the independent audit process. Some IOSCO jurisdictions directly regulate the audit profession.[18] In addition, as a result of recent financial scandals, a number of other jurisdictions have or are considering adjusting their approaches in this area.[19] Likewise, the International Federation of Accountants (IFAC), an international industry association that has spearheaded efforts to develop International Standards of Audit (ISAs) is in the process of forming a Public Interest Oversight Board (PIOB) to add greater public policy input into its workings and thereby improve the quality of IFAC's standards-setting procedures and the standards themselves.

Yet even effective auditor oversight might be insufficient to prevent audit failures that result because of fraud and the complicity of the auditors themselves. However, effective auditor oversight, combined with strong enforcement measures, may deter fraud from occurring in the first place, or detect it relatively soon after it has occurred.

An additional issue regarding auditor oversight is situations where international networks of auditors exist. These networks, which frequently market themselves under a single brand identity, are often composed of elements incorporated and regulated separately in a number of

[18] For example, in Italy, public oversight on auditing was established by law in 1975 and the Italian Consob supervises the activity of audit firms (which must be enrolled in a special Consob register) and monitors auditor independence requirements and technical qualifications. The Consob can also carry out investigations, impose sanctions on auditing firms, and recommend auditing principles.

[19] For example, in the United States, the Sarbanes-Oxley Act of 2002 established a Public Company Accounting Oversight Board (PCAOB) designed to oversee auditing standards for audits of public companies. The European Commission is currently considering requiring the formation of oversight systems within the member states of the European Union.

jurisdictions. Frequently, network members share information and resources amongst each other for some marketing and operational purposes, and may also have internal quality control reviews on a worldwide basis.

However, the extent of international quality control and policy implementation is often limited because of national laws mandating local control of audit firms, desires of the auditing firms to limit their liability for failures of a member of the network in another jurisdiction, and for other reasons. Work to remove these barriers to creating true international audit firms may be necessary. In addition, enhanced cooperation among regulators may be necessary to ensure proper oversight of the entire audit network.

b) Independence of Board Audit Committees

Recent financial scandals have, in particular, highlighted the importance of having board audit committees or similar bodies, independent of management, that are responsible for hiring or proposing for shareholder approval an independent public auditor, and overseeing the auditor's activities.[20] Auditors, when hired by and reporting to an issuer's senior management — and, in particular, its chief executive officer or chief financial officer — may face serious conflicts of interest that undermine the effectiveness of an audit. To some degree, independent oversight of the audit function is a *sine qua non* for effective board oversight as even the strongest, most independent boards of directors (like the shareholders they represent) depend to a considerable degree on the accuracy of the financial statements reported to them, even where these boards themselves are ultimately responsible for the accuracy of these statements.

c) The Effectiveness of Current Audit Standards

Where audit firm employees are actively involved in a financial fraud even the most robust audit standards may be insufficient. When this is the case, external inspections by a relevant authority and internal audit firm compliance mechanisms may be more effective safeguards against fraud. This matter is complicated because, in the cross-border context, more than one set of auditing standards may be in question and these standards may vary in their requirements. Some jurisdictions with foreign issuers or domestic issuers with foreign subsidiaries may mandate that financial statements required of these issuers be audited in accordance with their own or comparable auditing standards. Differences in standards can be significant. For example, some audit standards require that auditors observe physical inventories, use external confirmations for bank balances and accounts receivable and obtain legal opinions as to the validity of certain sale and acquisition contracts. In other jurisdictions, these separate verifications may not be required and/or alternative procedures may be permitted.

Beyond the matter of basic safeguards and independent verifications is the question of what types of fraud regulators can reasonably expect auditors to detect even with robust auditing standards. Thorough forensic audits used by regulators and law enforcement agencies – and

[20] In some jurisdictions, the board of directors is responsible for preparation of the issuer's financial statements and the independent auditor, rather than reporting to the board, is responsible directly to the issuer's shareholders. In these jurisdictions, shareholders vote on whether to hire an outside auditor that, typically, has been proposed by a board subcommittee or similar entity.

issuers conducting their own internal investigations – to uncover and prosecute financial fraud are time-consuming, expensive and generally ill suited to the review of quarterly and even annual financial statements. On the other hand, as a general matter, robust auditing standards can aid auditors in detecting many financial frauds and irregularities. Auditing standard setters are considering whether new standards for fraud detection during the audit of interim and annual financial statements will improve the auditor's opportunities to discover financial reporting fraud.

d) *Auditor Rotation*

As a result of recent financial scandals, several jurisdictions have considered or have adopted mandatory auditor rotation as a way of helping ensure that independent auditors truly remain independent and do not become too close to the issuers they audit. Auditor rotation, perhaps combined with limits on the types of non-audit services a firm may offer an issuer it audits, have been cited as possible remedies to looming conflicts of interest that may cause an auditor to ignore possible financial irregularities for fear of offending a cherished client. Some jurisdictions (such as the United States) have adopted a form of auditor rotation that requires the audit firm partners significantly involved in the audit to change periodically (leaving the larger audit team intact and minimizing the loss of experience gained from auditing the issuer), while other jurisdictions mandate a rotation of others on auditor engagement teams or the entire audit firm. Some jurisdictions (such as Italy and Brazil) have adopted requirements mandating complete changes of audit firms. A large majority of IOSCO jurisdictions, however, impose no auditor rotation requirements.

e) *Issuers with Cross-Border Operations and Multiple Auditors*

Issuers with subsidiaries in more than one jurisdiction often hire separate auditors to audit the financial statements of these related entities. Separate auditors may be used because local regulations may require that an auditor be licensed in that jurisdiction in order to conduct audits. In many cases, even auditors that are members of the same auditor "network" are, in fact, legally separate and distinct partnerships, despite marketing themselves as a single unified firm and having globally centralized policy-making and governance bodies. Financial information from these separately-audited subsidiaries frequently must be included in the financial statements of the parent. The result is that the auditor for the overall organization must review and opine on the accuracy of the organization's consolidated financial statements when it itself did not conduct an audit of all of the organization's components. Under such a situation, problems can arise if an audit failure occurs at the local level and the parent auditor is unaware of the failure.

Auditing standard-setting bodies have generally taken two different approaches to addressing this potential problem. The first approach requires the auditor for the overall organization (the parent) to assume accountability for the audit of the accuracy of the financial statements of the entire organization, including its subsidiaries or operations that are audited by other auditors. A second approach is to assign and disclose accountability for portions of the audit that are conducted by other auditors, according to the auditor responsible for the audit of each subsidiary or operation involved.[21] Each approach has its proponents and detractors.

f) Consolidation in the Audit Industry

Currently, there are only four large international accounting firms frequently used by large international issuers — Deloitte Touche Tohmatsu (Deloitte), PricewaterhouseCoopers (PwC), KPMG, and Ernst & Young (E&Y). Consolidation in the accounting industry has been rapid and the result both of mergers (e.g., Deloitte, PwC) and disintegration (e.g., Arthur Andersen). As the Technical Committee's Standing Committee on Multinational Disclosure and Accounting (Standing Committee 1) reported in a note to the IOSCO Chairs Committee in 2002, the effect audit industry consolidation has had on audit quality is unknown. On one hand, fewer firms could result in less competition and lower audit quality. Fewer firms may mean a lower level of competition, though this may not necessarily be so, as economists have argued that fewer competitors do not necessarily translate into less competition.[22] Similarly, it is not clear how lowering the level of competition will change audit quality, though this may also be a concern.

Further, the effect recent regulatory changes may have on competition in the audit industry is also unknown. The Standing Committee 1 note suggested that cross-selling of consulting with audit services has suppressed the price issuers pay for audits, making it more difficult for non-Big Four firms, which typically do not have large consulting arms, to compete. Since 2002, however, some IOSCO members have prohibited cross-selling of audits with many types of consulting and tax services. Also, since 2002, several smaller audit firms have gained clients, partly as a result of the demise of Arthur Andersen, a "Big Five" accounting firm.

2. Existing Standards and Principles

IOSCO has undertaken considerable work regarding *auditor oversight* issues. In 2002, the Technical Committee released its "Principles for Auditor Oversight," which laid out a comprehensive set of objectives that any auditor oversight approach should strive to achieve.[23] These Principles for Auditor Oversight note that auditor oversight should take place at several levels — within the audit firm, by professional associates, and through government regulation. However, the Principles for Auditor Oversight state that, within jurisdictions, audit firms should be subject to oversight by some body that acts and is seen to act in the public interest. Further, this auditor oversight body should have in place a regular review process designed to ascertain whether audit firms adhere to quality control policies and procedures that address all significant aspects of auditing.

---

[21] In the European Union, planned amendments to the 8th Company Law Directive will require the principal auditor of EU issuers to take full responsibility for consolidated financial statements. Other jurisdictions, however, have reaffirmed their conclusions that quality audits can be performed under either approach to assigning responsibility.

[22] Economists frequently cite both the automotive and airline manufacturing industries as examples of markets in which cut-throat competition exists side-by-side with relatively few competitors.

[23] "Principles for Auditor Oversight," cited in note 2.

IOSCO has also undertaken work in the area of emphasizing the importance of *independent board audit committees* in overseeing the audit. In 2002, the Technical Committee also drafted Principles of Auditor Independence and the Role of Corporate Governance in Monitoring an Auditor's Independence.[24] These Principles state that:

> *…regardless of the particular legal structure in a jurisdiction, a governance body that is in both appearance and fact independent of management of the entity being audited and acts in the interests of investors should oversee the process of selection and appointment of the external auditor and the conduct of the audit.*

Audit standards, traditionally, have been set by individual regulatory agencies or professional associations in IOSCO member jurisdictions. However, many jurisdictions currently are considering requiring the use of International Standards on Auditing (ISAs) in the review of financial statements of their issuers. The International Federation of Accountants (IFAC), the ISA standard-setting body, recently has enacted reforms to the process by which ISAs are set, to improve both the standards themselves and the independence of the standards-setter. The dialogue among IFAC, securities, banking and insurance regulators, and industry groups that led to these reforms may make it possible that improved ISAs could act as something of a "meta-standard" against which local auditing standards can be measured. .

Standing Committee 1 is engaged in a number of projects regarding ISAs, including consultations with IFAC on further developing and improving ISAs, and a continuing assessment of ISAs as they are developed by IFAC. Standing Committee 1 is also monitoring the development and improvement of ethics and independence standards set by the IFAC Ethics Committee.

Currently, international auditing standards projects have begun to provide additional guidance regarding requirements for *auditor rotation* or regarding audits of *issuers with cross-border operations and multiple auditors*.

As noted above, the Technical Committee's Standing Committee 1 undertook a discussion and fact-finding project related to *audit industry consolidation* in 2002 that highlighted certain issues consolidation may raise, but no international set of standards or best practices regarding this issue were deemed necessary at the time.[25]

3. Technical Committee Action Items

Issues relating to auditors and audit standards have figured prominently in most of the recent major financial scandals. However, these issues are wide-ranging, and the Technical Committee will focus on a few select areas where improvement and/or coordination may be most necessary, including:

[24] Cited in note 3.

[25] In 2003, the US General Accounting Office also published a study of audit industry consolidation, as required under the Sarbanes-Oxley Act of 2002. A copy of this study can be accessed from the GAO's website at: http://www.gao.gov/new.items/d03864.pdf.

- Developing recommendations as part of the implementation survey of the IOSCO Auditor Oversight Principles that would assist IOSCO members in accelerating implementation of these Principles;

- Prioritizing ongoing Technical Committee work being conducted by its Standing Committee on Multinational Disclosure and Accounting to uncover any trends that may exist with regard to recent audit failures indicating one or more problematic areas in current audit standards;

- Coordinating with public audit oversight boards, through its Standing Committee on Multinational Disclosure and Accounting, to investigate whether auditor verification approaches allowed under current audit standards are easily circumvented by those intent on committing financial fraud;

- Coordinating with public audit oversight boards, through its Standing Committee on Multinational Disclosure and Accounting, to undertake a fact-finding study to determine whether auditors have basic measures in place to help safeguard against complicity in a financial fraud by their own employees or local branch managers; and,

- Determining, through coordinated work between the Standing Committee on Multinational Disclosure and Accounting and public audit oversight boards, whether ways exist to enhance regulatory cooperation in the area of auditor oversight that can diminish risks posed by multiple auditors.

C. Financial and Non-Financial Statement Disclosure Requirements

1. Issues

Most recent financial scandals involved a failure of a public issuer to disclose information that an investor would want to know when investing in the company. In several recent fraud cases, the financial and non-financial statements disclosed by these issuers failed to indicate the size of each company's debts. In most of these scandals, securities regulators have alleged that issuers disclosed completely inaccurate information in order to convince investors that their financial prospects were far better than, in reality, they were.

Such alleged frauds were possible because most securities regulators today rely on a disclosure-based method of regulation.[26] Investors vary in their tolerances for risk and their investment time-horizons. The securities issued by public companies also vary according to risk and time-horizon. Disclosure-based securities regulation assumes that, provided they are given accurate and complete information, investors are in the best position to determine whether the potential benefits offered by a given security outweigh the risks they are willing to take.

To give investors an accurate and complete picture of the potential risks and prospects posed by an issuer, nearly all securities regulators today require issuers to make financial disclosures.

[26] "Merit-based" securities regulation, by contrast, involves a regulator assessing the "merits" of the proposed offering prior to it being sold to the public.

Financial disclosures are designed to provide investors with an accurate and fair understanding of the current financial position of the issuer, based on a set of recognized accounting standards designed to standardize how transactions are measured and allow investors to draw comparisons between the performances of different companies. However, information contained solely in an issuer's financial statements often provides an incomplete picture of an issuer's financial prospects. Consequently, many jurisdictions require that issuers also disclose all other material information as well — information that a reasonable investor would want to know when making an investment decision. Such "non-financial statement disclosure" does not lend itself to universalization to the same extent as is possible with accounting principles, so securities regulations in this area tend to lay out broad areas and types of events that issuers should disclose.

In order for issuers and their boards of directors to make full and accurate financial and non-financial statement disclosures, issuers need strong and thorough internal control systems that capture and verify the types of information needed for these disclosures. These internal controls are important to investors, who rely on issuer disclosures when making investment decisions, as well as management itself, which relies on internal controls to assess the performance of its operations and compliance programs.

2. *Existing Standards and Principles*

Because issuer disclosure plays such a central role in modern securities regulation, the Technical Committee has undertaken several projects in the area of financial and non-financial statement disclosure. These include:

- "General Principles Regarding Disclosure of Management's Discussion and Analysis of Financial Condition and Results of Operations" (February 2003);[27]
- "Principles for Ongoing Disclosure and Material Development Reporting by Listed Entities" (October 2002);[28]
- "Adapting IOSCO International Disclosure Standards for Shelf Registration Systems" (March 2001);[29]
- "Report on Implementation of International Disclosure Standards" (May 2000);[30] and,
- "International Disclosure Standards for Cross-Border Offerings and Initial Listings by Foreign Issuers" (September 1998).[31]

---

[27] Cited in note 5.

[28] Cited in note 4.

[29] This document can be downloaded from IOSCO's On-Line Library at www.iosco.org (IOSCOPD118).

[30] This document can be downloaded from IOSCO's On-Line Library at www.iosco.org (IOSCOPD106).

[31] This document can be downloaded from IOSCO's On-Line Library at www.iosco.org (IOSCOPD81).

The IOSCO Principles for Ongoing Disclosure and Material Development Reporting by Listed Entities, in particular, require extensive financial and non-financial statement disclosures of all material information on a timely basis.

In addition, Standing Committee 1 is currently undertaking several work streams that have a direct impact on this area. These include:

- *Review of enforcement of application of financial reporting standards*, which focuses on the range of activities and powers available to regulators and others in reviewing issuer financial statements, regardless of the accounting standards used;

- *Regulatory interpretations of International Financial Reporting Standards* (IFRS), which is designed to promote communications among IOSCO members so that the application and enforcement of IFRS will be consistent across jurisdictions that use IFRS;

- *Developing international debt disclosure standards*, to enhance disclosures for corporate debt offerings (described in more detail below in Section II.D);

- *International Accounting Standards Board (IASB) IFRS Project*, in which Standing Committee 1 continues to work closely with the IASB in developing IFRS; and,

- *Principles for Periodic Disclosure*, which will develop a set of international minimum standards for what types of information should be disclosed on periodic (annual, quarterly, etc.) disclosure reports.

3. Technical Committee Action Items

In reviewing IOSCO's work in this area, the Technical Committee will:

- Undertake, through its Standing Committee on Multinational Disclosure and Accounting, a study of Technical Committee members regarding their internal control requirements for issuers.

D. Transparency and Regulation of Corporate Bond Markets

1. Issues

Corporate bond markets have figured prominently in at least one major recent financial scandal. Over the past ten years, this issuer relied heavily on bond market offerings to raise capital. Most of these bonds issuances took place outside the domestic market through placements to qualified/institutional investors and listing abroad.

In many (though certainly not all) jurisdictions, corporate bond markets differ from equity markets in two significant ways. First, corporate bonds frequently are traded on Over-the-Counter (OTC) markets, where institutional investors may be more comfortable than retail investors. Similarly, many corporate bonds listed on exchanges are frequently traded "off-market," between institutional dealers and buyers. These factors combine to make many primary and secondary bond markets' price-setting mechanisms less transparent than those of equity markets.

Transparency in primary and secondary bond market trading is important to securities regulators because, ideally, in a liquid market where trading is transparent, new information is rapidly incorporated into the price of a security. By contrast, opacity in these markets may disguise issues that might otherwise be noticed by investors. For example, in at least one recent financial scandal, it has been alleged that some institutional investors suspected that financial problems with the issuer existed and, accordingly, liquidated their positions in the issuer's debt securities. Normally, in a transparent market, such large-scale liquidations would affect the price of the security and might signal to other investors that doubts existed about the issuer's solvency. Yet, in this case, because trading was insufficiently transparent, these suspicions may not have been effectively incorporated into the price of the issuer's securities and other investors remained unaware of these doubts.

A second aspect of publicly-traded corporate bonds is that, in many jurisdictions, issuers of corporate bonds are not required to disclose as much information as is required of equity issuers. The logic behind this approach is that public debt offerings share much in common with private debt offerings, in that the principal investors are relatively sophisticated and have sufficient resources to conduct a proper due diligence examination prior to investing. Further, the risks being assumed by bond purchasers typically are less than those of equity investors and the fundamental concern is whether the disclosure is sufficient to give investors adequate information about the issuer's ability to repay the debt.

Other jurisdictions, by contrast, make no distinction between public debt and public equity offerings in terms of disclosure requirements. These jurisdictions argue that there is no firm dividing line between what constitutes a debt or equity security or between the risks investors in these securities face. Likewise, as outlined in the Technical Committee's May 2004 report on "Transparency of Corporate Bond Markets," corporate debt securities increasingly are being purchased by retail investors in addition to sophisticated institutional buyers. Consequently, some argue that allowing for different levels of disclosure for debt and equity securities may lead to regulatory gaps or create artificial preferences (among issuers, investors, or both) for one type of security over another, regardless of economic merit.

2. Existing Standards and Principles

The Technical Committee's Standing Committees are reviewing both bond market transparency, and bond issuance disclosures.

In May 2004, the Technical Committee's Standing Committee on the Regulation of Secondary Markets (Standing Committee 2) published a study of transparency in corporate bond markets. This project was a fact-finding study examining different trading and transparency arrangements among Standing Committee 2 jurisdictions. This report concludes that, while trading in corporate bonds on exchanges is generally transparent, trading and price-setting mechanisms for those bonds sold on OTC markets or "off-market" are typically opaque. The Standing Committee 2 report also found that, in many jurisdictions, monitoring and surveillance systems can be limited where bond trading takes place bilaterally or on OTC markets. The report concludes with a set of "core measures" that securities regulators can implement to improve bond market transparency and enhance their regulatory and reporting systems to meet the objectives laid out in the IOSCO Objectives and Principles of Securities Regulation (the IOSCO Core Principles).[32]

Currently, no international standards or principles exist regarding the types of disclosures that should be required of bond issuers. Standing Committee 1 is in the process of developing principles for debt securities disclosures as a follow-up to the 1998 IOSCO International Disclosure Standards for Cross-Border Offerings and Listings (IDS).[33] During the February 2004 Technical Committee meeting, however, Standing Committee 1 requested that this undertaking be redesigned so that, rather than a detailed line-item format similar to IDS, the project instead would analyze the objectives of disclosure with respect to debt securities, and set forth principles of disclosure (supplemented with more specific disclosure recommendations) that could be used to guide regulators in developing or reviewing a corporate bond disclosure regime.

3. Technical Committee Action Items

In reviewing the transparency and operation of global corporate bond markets, the Technical Committee will:

- Have its Standing Committee on the Regulation of Secondary Markets review the Technical Committee's report on Transparency of Corporate Bond Markets to determine how to improve the transparency of bond market trading and whether, in light of recent financial scandals, additional recommendations are necessary;

- Through work by its Standing Committee on the Regulation of Secondary Markets, develop mechanisms and best practices for implementing the recommendations contained in its report on Transparency of Corporate Bond Markets;

- Determine whether the current approach being considered by its Standing Committee on Multinational Disclosure and Accounting with regard to public debt issuance disclosure should be reconsidered in light of recent financial scandals involving publicly traded debt securities, and whether any international debt disclosure standards should include disclosures of related-party transactions and management's discussion of financial position and results of operations.

---

[32] Cited in note 1. IOSCO Core Principle 27 states, "Regulation should promote transparency of trading," while Principle 28 states, "Regulation should be designed to detect and deter manipulation and other unfair trading practices."

[33] Cited in note 30.

E. The Role of Market Intermediaries and Review of Transactions

1. Issues

Involved at all levels of many recent financial scandals have been a host of market intermediaries and gatekeepers that are a facet of all financial transactions in today's global capital market. Such intermediaries and gatekeepers include investment banks that acted as underwriters for public equity and debt issuances and brokered private loan arrangements as well as broker-dealers who marketed securities to institutional and retail investors.

Recent financial scandals have involved accusations of wrongdoing by underwriters and investment banks. In some cases, investment banks have been accused of arranging loans or other transactions that they knew lacked any economic substance and were clearly designed to circumvent accounting rules.

As part of a securities underwriting, market intermediaries frequently become aware of material non-public information about the issuer. In each of these examples, how market intermediaries make use of material non-public information is a regulatory matter. As with other possessors of "inside" information, market intermediaries may be in a position to misuse material non-public information, particularly when the intermediary is involved in the market in a number of ways — as an underwriter, lender, broker-dealer, market maker or proprietary trader. For example, investment banks that lend money to issuers and then learn that the issuer's financial condition is worse than anticipated may be in a position to broker subsequent public debt offerings so that the funds raised could be used to repay their own loans. Further, complex structured financial transactions may provide intermediaries in possession of knowledge of a company's dire financial condition with opportunities to transfer their risks to third parties.

In many jurisdictions, underwriters and other market intermediaries can be held liable for misstatements or omissions in a registration statement. However, these jurisdictions typically absolve from liability those underwriters that can demonstrate that they conducted a reasonable investigation and had good reasons to conclude that the disclosure statements were accurate and contained no material omissions.[34] In light of recent financial scandals, many securities regulators are reassessing the issue of what obligations investment bank underwriters owe to investors when these intermediaries are involved in publicly and privately placing securities, and whether, in the case of audited financial statements, reliance on statements by an independent auditor (or other "experts") is sufficient without further inquiry to discharge such obligations.

A separate issue is raised if bank personnel are directly implicated in a fraud. Rather than a question of what constitutes sufficient due diligence, the issue becomes a question of what types of internal controls are appropriate for investment banks to have to detect and deter fraud by their own employees.

---

[34] In many jurisdictions, this "due diligence defense" is often available to attorneys, experts and other market intermediaries and gatekeepers as well as underwriters. This is in marked contrast to the liability often imposed on the issuer itself, which in some jurisdictions can be held strictly liable for misstatements and omissions, even if made in good faith.

2. *Existing Standards and Principles*

Currently, no international standards exist on what level of review by an intermediary constitutes "proper due diligence" when underwriting a securities issuance or arranging a loan transaction. Within their own jurisdictions, however, several IOSCO members have recently issued guidance to their own firms in this area. In September 2004, the United Kingdom's Financial Services Authority (UK FSA) issued a letter to investment banking chief executives outlining for them existing UK standards for addressing management conflicts of interest and reputational risk and how these standards apply in the current business environment.[35] Similarly, in May 2004, US financial regulators released for public comment an interagency statement concerning complex structured finance transactions (CSFTs) undertaken by market intermediaries.[36] This interagency statement describes in broad detail the types of approval processes and internal oversight mechanisms investment banks should have in place as part of a "due diligence" review.

Regarding internal controls to protect against internal conflicts of interest undermining a firm's internal review of CSFTs, and to protect against personnel engaging in fraud, IOSCO Core Principle 23 states:

> *Market intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters.*

Currently, the Technical Committee's Standing Committee on the Regulation of Market Intermediaries (Standing Committee 3) is undertaking a project to identify what requirements different jurisdictions impose on intermediaries regarding their compliance function, whether any special qualifications are required of compliance officers, and how accountability and independence is managed. The result of the project would be a set of high-level principles to guide securities regulators considering new rules in this area.

Given regulator and intermediary interest regarding what constitutes an adequate review of a transaction for legal and reputational risks to the intermediary, particularly where cross-border securities issuances and other transactions are involved, additional international guidance in this area may be valuable.

3. *Technical Committee Action Items*

In light of the issues highlighted above, the Technical Committee will:

---

[35] Letter from Hector Sants, Managing Director, Wholesale and Institutional Markets, UK FSA re "Senior Management Responsibilities: Conflicts of Interest and Risks Arising from Financing Transactions" (17 September 2004), accessible via the Internet at: http://www.fsa.gov.uk/pubs/ceo/conflicts_24sept04.pdf.

[36] US Department of Treasury, US Office of Thrift Supervision, US Federal Reserve System, US Federal Deposit Insurance Corporation, and US Securities and Exchange Commission, "Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities," (May 13, 2004), accessible via the Internet at: http://www.sec.gov/rules/policy/34-49695.htm.

- ♦ Through its Standing Committee on the Regulation of Market Intermediaries, review the role played by intermediaries in recent financial scandals, determine whether that role contributed to the financial scandals and, if so, develop a set of principles for intermediary policies and procedures (including internal controls) concerning their financial transactions. Such principles should address such issues as the general nature of the policies and procedures intermediaries should use or have in place to mitigate reputational, legal and operational risks, approve new financial products and help ensure that these institutions are not conduits for fraudulent transactions or market manipulation schemes.

F. Complex Corporate Structures

1. Issues

Complex corporate structures and special purpose accounting entities (SPEs) have figured prominently in several recent financial scandals. This has led some commentators to conclude that these structures and SPEs serve little purpose other than to hide fraudulent activity and that they should be banned outright. Others, such as the European Commission, have recognized that complex corporate structures and SPEs can serve legitimate purposes, and, instead of prohibiting them, have proposed requiring issuers to disclose these structures and SPEs and the reasons behind why they have been created.

Complex corporate structures and SPEs can have a variety of legitimate uses. Financial institutions and project finance companies, for example, use them to lower their risks when investing in highly speculative projects. Large capital projects in many developing countries, for example, are based around a series of subsidiary companies, with a legally separate project company assuming most of the risk and with investment funds and revenues flowing into and out of complex "waterfall" accounts held by SPEs. These accounts and the SPEs are designed to protect the investor from expropriation, operational and exchange-rate risks. The subsidiaries are legally separate entities so that even if the project company fails, the finance company's losses are limited. SPEs and complex corporate structures may also be used to facilitate derivatives and currency hedging or to mitigate other types of financial risk, particularly where the parent company has cross-border operations that might be hurt by changes in an exchange rate, or where its operations rely on commodities such as milk, oil, wood pulp, steel, etc.

SPEs are often based in offshore financial centers in order to limit the investor/parent company's tax liability.

Since SPEs and similar entities are separate legal entities, many sets of accounting standards do not count the liabilities of the SPE on the balance sheets of the parent, provided certain conditions are met. SPEs and complex corporate structures become problematic — indeed, even fraudulent — when the sponsors of the structures use them to deceive market participants into believing risks that are still with the parent company have been transferred. In some cases, SPEs and complex corporate structures have been used to perpetrate accounting fraud by improperly transferring the parent company's liabilities to these off-balance sheet entities while no actual change in the issuer's debt takes place.

SPEs and similar entities tend to involve very complex ownership and lending arrangements. As noted above, some of these arrangements serve legitimate purposes. However, they also tend to make auditing of an issuer's liabilities and reviews of financial and non-financial statement disclosures difficult.

2. Existing Standards and Principles

In many cases, SPEs and other complex corporate structures function as they do because of existing accounting principles and rules governing corporate liability. The ability to transfer some risks away from the parent company (and its balance sheet) can encourage entrepreneurial risk-taking. However, problems arise where such risks remain with the parent and are only removed for purposes of the issuer's balance sheet or are otherwise used to obscure the liabilities the parent faces.

Accounting for special purpose entities is presently addressed in both standards and interpretations of the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB). Both Boards continue to monitor the need for improvements in accounting for SPEs and complex corporate structures and, as part of the IASB-FASB convergence project, work conducted by one standard-setter is considered by the other. The most recent standards setting activity in this subject area was FASB Financial Interpretation 46 and 46 R issued in 2003. The IASB is currently considering a project to address consolidation and SPEs/complex corporate structures, including consideration of SIC 12 (Consolidation — Special Purpose Entities), but the timing for this project has not been finalized.

3. Technical Committee Action Items

Given the regulatory issues relating to SPEs and complex corporate structures highlighted above, the Technical Committee will:

- In light of current work being undertaken by its Standing Committee on Multinational Disclosure and Accounting on the subject, determine whether the use of SPEs warrants additional disclosure in an issuer's non-financial statement disclosures.

G. The Role of Private-Sector Information Analysts

1. Issues

The amount of raw information available to today's investors is staggering. Consequently, investors increasingly rely on private-sector information analysts to assist them in monitoring and making use of this information. These information analysts range from popular business newspapers and magazines to investment advisers to securities analysts and credit rating agencies (CRAs).

Even more than broker-dealers and investment advisors who have been pilloried for giving bad advice, securities analysts and CRAs have been attacked in the popular media for failing to notice evidence of financial problems at several major issuers until just prior to the entity's collapse. For example, critics note that Standard & Poor's gave investment-grade ratings (albeit low investment-grade ratings) to several issuers just prior to those companies announcing significant financial restatements that have led to their bankruptcies. Likewise, several equity analysts, including equity analysts employed by firms with previous business dealings with these issuers, appear to have issued favorable research on these companies just prior to financial improprieties coming to light. Indeed, just prior to the bursting of the "Dotcom Bubble" in 2001, critics noted that security analyst "strong buy," "buy" and "hold" recommendations outnumbered "sell" recommendations sometimes by more than 99 to 1.[37]

Issues relating to securities analysts and CRAs are often conflated, but the specific problems cited tend to be quite different. In previous financial scandals, securities analysts, in particular, were accused of fully recognizing underlying issuer financial problems but deliberately ignoring them because of conflicts of interest. These conflicts of interest arise because sell-side securities analysts typically are employed by investment banks that may be involved in lucrative underwriting arrangements with the issuer. In many cases, securities analysts are used in the marketing of these underwriting services, further calling into question the independence of the analysts' opinions. Others conflicts of interest can arise where the analysts are employed by banking groups heavily exposed with loans to the issuers.

By contrast, there have been few specific accusations that CRA ratings — currently — are plagued by similar conflicts of interest.[38] Rather, CRAs typically have been accused of failing to perform adequate research into the companies they rate, failing to question the quality of an issuer's public auditor and failing to adequately account for risks associated with an issuer's operations in jurisdictions with weak accounting standards and lax regulatory oversight.

2. *Existing Standards and Principles*

IOSCO has recently addressed issues relating to securities analyst conflicts of interest and the activities of CRAs. In September 2003, the Technical Committee released a "Report on Analyst Conflicts of Interest"[39] and a "Statement of Principles for Addressing Sell-Side Securities Analyst Conflicts of Interest."[40] The latter has been cited as an impetus for reform in several IOSCO jurisdictions.

Likewise, in September 2003 the Technical Committee released a "Report on the Activities of Credit Rating Agencies"[41] and a "Statement of Principles Regarding the Activities of Credit

---

[37] "How Can Analysts Maintain Their Independence?" Remarks by Acting Chairman Laura S. Unger, US Securities and Exchange Commission (Ray Garrett Jr. Corporate and Securities Law Institute, Northwestern University School of Law, April 19, 2001). This speech can be accessed from the US SEC's website at: http://www.sec.gov/news/speech/spch477.htm.

[38] Although CRA conflicts of interest are frequently cited as a potential, these critics rarely point to specific instances of CRA conflicts of interest leading to biased ratings. By contrast, specific allegations of security analyst conflicts of interest have been documented in considerable detail, both in press reports and in court filings.

[39] This document can be downloaded from IOSCO's On-Line Library at www.iosco.org (IOSCOPD152).

[40] Cited in note 6.

[41] This document can be downloaded from IOSCO's On-Line Library at www.iosco.org (IOSCOPD153).

Rating Agencies" (IOSCO CRA Principles).[42] The IOSCO CRA Principles have received praise from governments and industry alike and led to Technical Committee to develop the IOSCO "Code of Conduct Fundamentals for Credit Rating Agencies" that offers practical measures by which CRAs can implement the IOSCO CRA Principles. The CRA Code of Conduct Fundamentals was published by the Technical Committee in December 2004.[43]

3. Technical Committee Action Items

- No additional actions planned for the immediate term.

[42] Cited in note 7.

[43] This document can be downloaded from IOSCO's On-Line Library at www.iosco.org (IOSCOPD180).

III. IMPLEMENTATION OF EXISTING REGULATORY STANDARDS AND PRINCIPLES

As outlined in Section II, many of the regulatory issues highlighted by recent financial scandals are already addressed by existing international standards or principles. In some cases it can be argued that some of these standards and principles are inadequate to the task at hand or might benefit by being supplemented to take into account the lessons regulators have learned as a result of recent events. In other cases, however, the relevant standards and principles are relatively recent innovations and there may have been insufficient time for regulators and the financial community to implement them to the degree necessary to counter the problems they were designed to address.

This fact, in turn, draws attention to the importance of widespread and thorough implementation of international regulatory standards and principles. As a result of intense discussions over the past few years among financial regulators and market participants around the world, possible solutions to recognized threats to global capital market stability in many cases already exist and are widely agreed upon. However, it is unknown whether these standards and principles are universally implemented.

Because even the highest possible standards and principles are of little value if they are not effectively put into force, promoting and assessing the implementation of existing standards and principles among its members, then, becomes a vital tool that IOSCO can use to strengthen global capital markets against fraud. In some cases, it may well be that promoting the implementation of existing standards and principles will deter fraud and strengthen the integrity of capital markets to a greater extent than developing additional standards and principles more directly targeted at the problem at hand.

Consequently, going forward, the Technical Committee will emphasize implementation of all existing regulatory standards and principles among IOSCO members, using implementation assessment surveys, setting implementation benchmarks, and making implementation a cornerstone of IOSCO's technical assistance program.

In focusing on implementation, the Technical Committee is taking note of the following:

Corporate Governance. In 2002-2003, the OECD conducted a survey of corporate governance developments among member countries. However, to date there has been no comprehensive, global assessment of the degree to which the OECD Corporate Governance Principles themselves have been adopted among OECD members or within most IOSCO jurisdictions. The IOSCO Technical Committee intends to encourage the OECD to proceed with such an assessment. As outlined in Section II.A.3, above, an additional, thematic analysis by the OECD of the definition and role of independent directors on the boards of issuers may assist IOSCO members in fully implementing those OECD Corporate Governance Principles relating to board independence.

Auditors and Audit Standards. The Technical Committee's Standing Committee on Multinational Disclosure and Accounting is currently undertaking a survey of its members regarding auditor oversight, which includes its members' implementation of the IOSCO Auditor Oversight Principles. This review is expected to be completed by early 2005. The

Technical Committee may decide to use this implementation assessment as a model for other sets of IOSCO Principles.

Financial and Non-Financial Statement Disclosures. Following completion of its implementation survey of IOSCO Auditor Oversight Principles, the Technical Committee may ask its Standing Committee on Multinational Disclosure and Accounting to undertake a similar survey of members' implementation of the IOSCO Principles for Ongoing Disclosure and Material Development Reporting.

Transparency and the Regulation of Corporate Bond Markets. The core measures outlined in the Technical Committee's Report on Transparency in Corporate bond Markets are high-level. Rather than describing what securities regulators should do, these measures broadly outline what types of information regulators should have access to and what types of surveillance of bond market trading they should undertake. Yet, despite their high-level approach, the Technical Committee's Standing Committee on Secondary Markets acknowledges that most Technical Committee jurisdictions have not implemented these measures. Future work by the Standing Committee on Secondary Markets will include an assessment of the degree to which member jurisdictions have implemented the types of surveillance and information-collection recommended in the report.

Market Intermediaries. The Technical Committee's Standing Committee on the Regulation of Market Intermediaries currently is working on a project on the compliance function that will offer significant additional guidance on how compliance within market intermediaries can be improved in practice, and will outline steps securities regulators can take to improve their oversight of this area. Notably, Standing Committee 3's project will also assess current regulatory practice in this area, which may serve as a baseline for future implementation assessments once principles in this area are developed.

Complex Corporate Structures. Current work being undertaken by the IASB may result in enhanced methods of accounting for complex corporate structures. This work, by its nature, likely will require ongoing consideration by the IASB and local accounting standard-setters and an assessment of implementation by those jurisdictions that use International Financial Reporting Standards.

Private-Sector Information Analysts. The IOSCO Securities Analyst Principles, the CRA Principles and the CRA Code of Conduct Fundamentals are recent developments and there has not yet been an assessment of their implementation within IOSCO jurisdictions. As the Securities Analyst Principles are directed primarily at securities regulators, future implementation assessments may best begin in this area.

IV. CROSS-BORDER ENFORCEMENT COOPERATION

IOSCO members recognize that strong enforcement measures, along with thorough implementation, are necessary for high-quality regulatory standards and principles to have value. Today, capital markets are global. Consequently, effective enforcement of laws and regulations applying to activity on these markets necessarily entails a global component. Yet because regulatory oversight and law enforcement is local, effective enforcement today requires extensive enforcement cooperation among financial regulators and law enforcement agencies in different jurisdictions.

Several recent financial scandals are examples of this dichotomy between global markets and local enforcement. These scandals have been notable not just because of their cross-border nature of the alleged wrongdoing, but also because of the cross-border enforcement cooperation among securities regulators and law enforcement authorities that followed. In most of these investigations, cross-border information-sharing and enforcement cooperation has proven vital to uncovering securities law violations and prosecuting those responsible. The aim of such cooperation has been to collect evidence, to identify the location of ill-gotten proceeds, to obtain documents necessary to investigating and prosecuting the case, and to freeze assets related to a securities law violation.

The inescapable importance cross-border enforcement cooperation now holds for securities regulators has led IOSCO to spearhead efforts to promote enforcement information-sharing among its members. IOSCO's efforts in this area include the Multilateral MOU,[44] the inclusion of information-sharing as an IOSCO Core Principle,[45] and the development of regulatory principles on client identification and beneficial ownership (CIBO Principles),[46] each designed to improve the abilities of securities regulators to access information regarding the individuals and entities that actually control or benefit from a financial transaction. IOSCO's efforts have also included collaboration with other international organizations, such as the Financial Action Task Force (FATF), which has directly incorporated cross-border cooperation under certain circumstances among law enforcement agencies and financial regulators into its Forty Recommendations.[47] IOSCO's endeavors in this area have been remarkably successful in encouraging regulators from a number of jurisdictions with no history of enforcement cooperation to obtain the necessary authority from their legislatures to permit such cooperation.

Yet despite years of work by IOSCO in this area, not all securities regulators have the ability to provide enforcement cooperation to their foreign counterparts. This inability is not necessarily limited to smaller, less developed markets. The inability to offer enforcement cooperation — particularly by regulators in larger markets — can present difficulties not only for investor

[44] Cited in note 8.

[45] Cited in note 1.

[46] "Principles on Client Identification and Beneficial Ownership for the Securities Industry," (May 2004). This document can be downloaded from IOSCO's On-Line Library at www.iosco.org (IOSCOPD167).

[47] See Section D, "The Forty Recommendations," (The Financial Action Task Force on Money Laundering, 2003). In particular, Recommendation 40 states: "Countries should ensure that their competent authorities provide the widest possible range of international co-operation to their foreign counterparts."

protection and undermine other regulators' efforts to police their own markets, but may also have an impact on international financial stability. By contrast, prosecution of several recent high-profile cases depended on the remarkable efforts made by regulators to assist their foreign counterparts, proving that the Technical Committee's efforts can bear fruit and underscoring the importance of future efforts to close any regulatory gaps created by a lack of implementation of IOSCO standards regarding cross-border enforcement cooperation.

As modern capital markets become even more global in nature, the importance enforcement cooperation holds for international financial stability will only grow. If nothing else, recent high-profile cases have highlighted, in particular, two key issues: (1) the opportunity IOSCO now has to establish high standards of cross-border enforcement cooperation as a benchmark for continued IOSCO membership; and, (2) the priority the international financial regulatory community places on promoting cross-border enforcement cooperation in offshore financial center (OFC) jurisdictions.

A. Enforcement Cooperation Among IOSCO Members

Information-sharing and cross-border enforcement cooperation are enshrined directly within the IOSCO Core Principles. In particular, Core Principles 11-13 state:

11. *The regulator should have authority to share both public and non-public information with domestic and foreign counterparts.*

12. *Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.*

13. *The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers.* [48]

In an effort to create a concrete mechanism to implement the IOSCO Core Principles that deal with cross-border enforcement cooperation, in 2002, IOSCO created a Multilateral MOU through which signatories agree to share a range of enforcement-related information with each other.[49] However, the IOSCO Multilateral MOU is more than just an information-sharing mechanism. Signing the agreement involves a review process through which prospective signatories must demonstrate they have the legal authority to provide the kinds of assistance the Multilateral MOU describes. Signing the IOSCO Multilateral MOU necessarily entails an extensive assessment of the prospective signatory's implementation of IOSCO's Core Principles in this area.

For IOSCO members, the types of information exchange outlined in the Multilateral MOU are extensive. Signatories to the Multilateral MOU must be able to obtain on behalf of other signatories such information as brokerage and bank account records and witness testimony. To

[48] Cited in note 1.

[49] Cited in note 8.

date, 26 IOSCO members have acceded to the Multilateral MOU, many of which specifically sought from their legislatures the legal authority to provide enforcement assistance to foreign counterparts in response to IOSCO's efforts in this area. Another 23 jurisdictions have applied to sign the agreement. In addition, 5 jurisdictions are listed on an "Appendix B" of the Multilateral MOU, indicating that, although they currently lack the powers to provide the requisite assistance to their counterparts, they are committed to the objectives of the Multilateral MOU and are actively seeking the authority to provide such assistance.

To further advance international enforcement cooperation, the Technical Committee's on Enforcement and Exchange of Information (Standing Committee 4) recently completed a review of non-cooperative and under-regulated jurisdictions (including those described as offshore financial centers, as discussed below) that is designed to obtain from jurisdictions greater enforcement cooperation and also to assist the Executive Committee in its IOSCO membership admissions process. This project has resulted in a draft workplan for the Technical Committee to encourage more cross-border enforcement cooperation among securities regulators by establishing the Multilateral MOU as a clear standard of what is expected of IOSCO members.

Currently, Standing Committee 4 is engaged in a number of projects aimed at continuing to improve cross-border information sharing. These projects include:

- Developing a guide on the various avenues available to members in seeking information-sharing and enforcement cooperation following the institution of proceedings;

- A review of the abilities of securities regulators to preserve and repatriate assets on behalf of their overseas counterparts with an objective of eventually improving these abilities among Technical Committee members; and,

- A continuing review of current trends in securities and futures violations, designed to assist securities regulators in detecting likely problematic practices before they become widespread.

B. Cross-Border Enforcement Cooperation and Offshore Financial Centers

Many recent financial scandals have focused attention on OFCs and their abilities to share enforcement-related information with other jurisdictions. Many of the subsidiaries and SPEs implicated in these cases in efforts to disguise issuer debt were incorporated in OFCs and, in some cases, regulators were unable to collect information essential to an investigation from the supervisors based in these jurisdictions. Further, historically, regulators in several prominent OFC jurisdictions have been unable or unwilling to cooperate with their foreign counterparts.

Issuers often choose to incorporate themselves and/or their subsidiaries in OFCs because OFCs do not tax the income of business entities that do not actually conduct operations in their jurisdictions. Consequently, an SPE can be incorporated in an OFC and take on the liabilities of a potentially risky business venture, but transfer the profits of the venture to the parent organization without taking on additional tax liability. Because OFCs receive considerable income from incorporation fees and similar charges on the entities registered in their jurisdictions, they compete among each other in making the incorporation process rapid and easy.

OFCs often are accused by critics of making other jurisdictions' task of enforcing their own laws considerably more difficult. OFCs have been viewed by other financial regulators and law enforcement authorities as being both uncooperative with foreign enforcement investigations and generally requiring inadequate record keeping of entities registered in their jurisdictions or of individuals and entities with bank accounts in their jurisdictions. Several OFCs have undertaken reforms and appear to be in a better position to cooperate with their foreign counterparts than they have been in the past. However in some cases this cooperation must occur through judicial channels, which may face restrictions such as dual criminality requirements and sometimes long and uncertain judicial processes in order to provide information requested through judicial cooperation. Regulatory authorities in some cases are unable to cooperate in exchanging information with financial supervisors or law enforcement authorities abroad and they may attach requirements such as restrictions on passing the information on to criminal authorities. Further, because some OFCs regulate entities incorporated in their jurisdictions lightly and frequently have no client identification or beneficial ownership reporting requirements, cross-border enforcement cooperation is difficult even where legally possible.

Financial regulators in OFC jurisdictions are not unique in their abilities (or inabilities) to cooperate with their foreign counterparts in enforcement cases. However, the significant role OFCs play in the global capital market means that their inability to provide enforcement-related information to other regulators may pose greater systemic risks to financial stability than might similar inabilities in other jurisdictions with less of a nexus to the global financial system. Further, because the financial sector frequently makes up a significant portion of the economies of many OFCs, more cooperative jurisdictions may feel competitive pressures if other, less cooperative, OFCs "market" themselves as offering a more "anonymous" or "less bureaucratic" legal system. Similarly, the common perception that OFCs are secret havens for securities fraudsters and money launderers is damaging to those OFCs that have worked hard to improve their abilities to cooperate with foreign counterparts.

Much of the work of Standing Committee 4 and the Client Identification and Beneficial Ownership Task Force is either directed at or directly applicable to OFCs. The benchmark set forth in the IOSCO MMOU regarding information-sharing and cross-border enforcement cooperation, if implemented by OFCs, would greatly improve the abilities of all IOSCO members to enforce their jurisdictions' securities laws. Likewise, the Technical Committee's CIBO Principles set out best practices for regulators (including OFC financial regulators) and financial institutions regarding what types of record-keeping should be required of individuals and entities. Implementation of the CIBO Principles within OFCs would greatly reduce their attractiveness to individuals who are intent on committing securities fraud.

Work by other organizations — particularly the Financial Action Task Force — also lays out principles and criteria for enforcement cooperation and CIBO record-keeping. The FATF's past work identifying problematic jurisdictions has proved very successful at encouraging many OFCs to improve their abilities to share enforcement-related information with foreign law enforcement authorities, at least where money laundering or terrorist financing is suspected. A similar IOSCO approach may be helpful insofar as "uncooperative" OFC jurisdictions are identified and engaged with in a manner that will assist and encourage them in rectifying problems that inhibit cross-border cooperation. Either in coordination with the FATF or independently, IOSCO might then be able to take additional remedial measures to address risks that remain as a result of those OFCs that remain unwilling or unable to assist other jurisdictions in cross-border enforcement activities. Such protective measures may include requiring their own market intermediaries to exercise special precautions when engaging in transactions involving entities located in those jurisdictions.

Given IOSCO's extensive work on cross-border cooperation and information-sharing, as well as the development of CIBO Principles, the single greatest matter still facing many OFCs is implementation of these existing principles. However, some OFCs argue that they lack the legal infrastructure to offer adequate cross-border enforcement cooperation and that extensive client identification and beneficial ownership requirements would make registration in an OFC more costly and less attractive. Consequently, future Technical Committee work in this area will be mindful of the competitive pressures OFCs face. This future work, therefore, will emphasize to OFCs the benefits to be gained through greater cross-border enforcement cooperation, as well as the costs that a continued lack of cooperation may entail.

C. Technical Committee Action Items

In its continuing effort to promote cross-border enforcement cooperation among both IOSCO members generally, and OFCs in particular, the Technical Committee will:

- Conduct, through its Standing Committee on Enforcement and Exchange of Information, an analysis aimed at checking whether OFCs have in place legislation that is adequate to ensure that information is collected and shared among supervisory authorities in a cooperative and non-discriminatory manner.

- Encourage the IOSCO President's Committee to adopt the IOSCO Multilateral MOU as a clear benchmark for enforcement cooperation among IOSCO members with the goal of eventually making the ability to sign on to the Multilateral MOU a primary benchmark for continued IOSCO membership; and

- Prioritize, using market size and importance to the global financial system as criteria, those under-regulated and uncooperative jurisdictions that are most problematic for cross-border enforcement and, through its Standing Committee on Enforcement and Exchange of Information, develop a work plan on how these jurisdictions can best be encouraged to improve their regulatory oversight and abilities to cooperate with cross-border enforcement investigations, using the Multilateral MOU as the benchmark against which cross-border enforcement cooperation will be assessed.