

IS REGULATION KEEPING UP WITH OR FETTERING CROSS-BORDER DEVELOPMENTS?

Jane Diplock AO
Chairman

Executive Committee of IOSCO & Securities Commission, New Zealand

ASIC Summer School, 17 February 2006

Introduction

This session has a daunting title. I'm asked, in effect, to critique the endeavours of IOSCO and its member regulators worldwide!

Let me break the title into two questions and respond to each in turn. First, is regulation keeping up with the globalisation of securities markets? That is probably the most fundamental question for both organisations I am currently privileged to chair.

Second, is regulation fettering developments? That is also a key question, and one that stimulates the type of debate that is welcomed by IOSCO.

I will attempt to answer both questions today, but first let's put them into their current context.

Market trends

A number of market trends are confronting regulators all around the world. First and most obvious is an explosion in the size of securities markets. This growth has been fuelled by expanding trade and cross-border business activity, by advances in information technology, and by the deregulation of many national economies since the 1980s.

McKinsey's recently published survey data puts the world's stock of financial assets at 136 trillion US dollars, up by more than 150% over the past 10 years. The growth is unrelenting, and concentrated heavily in debt and equity securities. Other figures, from the World Federation of Exchanges, show a 40% jump in the value of new capital raised during 2004 alone. The markets are definitely back in business after the set-back when the technology stocks bubble burst earlier this decade!

The second, related trend is the increasing scale and complexity of multinational entities that operate in this expanding market. These include large industrial and trading firms, and financial intermediaries and institutional investors of every type.

Current IMF data shows that institutions based in OECD countries now have over \$45 trillion of assets under management, and an increasing portion of this is in funds invested across international borders. The total has grown by 20% in the past four years. Hedge funds, which now hold around \$1 trillion, are particularly fast growing players that operate mostly through complex international structures.

A third market trend is that both the scale and diversity of risk in securities markets continue to grow rapidly. The Financial Stability Forum recently highlighted the escalating risk that accompanies the growing size and complexity of institutions, the emergence of new players like hedge funds, and the sheer complexity of various financial products. The FSF, as you would expect, is calling for institutions generally to strengthen their risk management practices. Among all the sources of risk, fraud and other forms of market misconduct are of particular concern to the world's securities regulators.

A fourth trend relates to regulation within each sovereign jurisdiction. Increasingly, regulators find they must look beyond their borders if they are to ensure that their own market is fair and effective, that investors are adequately protected, and that systemic risks are managed.

My IOSCO colleague, US Securities & Exchange Commissioner Roel Campos, has recently described the situation in these terms: "The ability to enforce one's own laws within one's own borders increasingly depends on the ability to cooperate with foreign regulators and law enforcement authorities. Globalisation and the technology of the 21st century demand that regulators create a collaborative global system of regulation."

Is regulation keeping up?

Background on IOSCO

So to the first question, "Is regulation keeping up?" I answer with a qualified "yes".

Regulation is, in general terms, keeping up with cross border developments. In support of this contention I point to IOSCO's progress on many issues common to regulators worldwide. For those not familiar with it, IOSCO – the International Organization of Securities Commissions – is firmly established as the world's leading body for standard setting for regulation of securities markets.

Its members come from over 100 national jurisdictions and regulate more than 90% of the world's securities markets. IOSCO's high standing, alongside the Basel Committee on Banking Supervision and the International Association of Insurance Supervisors, is widely recognised in the world's financial community.

Indeed, IOSCO is something of a rarity among international organisations for its track record in building consensus among a wide diversity of national regulators on some very challenging issues. That said, we still have a very full agenda and we are under no illusions about the work required to sustain that track record and maintain IOSCO's reputation.

Over recent years, IOSCO has delivered numerous reports, codes and standards on issues of importance. In 1998, IOSCO adopted a comprehensive set of 30 core principles of securities regulation for implementation in all member jurisdictions. The aim is to set standards that are meaningful and relevant, while allowing flexibility to implement them in the manner most appropriate to each jurisdiction, given the wide range of legal traditions and economic differences among IOSCO members. The principles laid the foundation for much of the detailed work undertaken since.

There is now an increasing focus on implementing the core principles and on cross-border cooperation for information exchange and regulatory enforcement. IOSCO recognises that cooperative action between two or more national regulators is where "the rubber hits the road" in the regulation of securities markets globally. I will talk more about this later.

IOSCO's fundamental, shared goals are the promotion of investor confidence and market stability. Its role includes the facilitation of market growth across borders to achieve greater productive investment and economic prosperity for all concerned. Regulation, in our view, must certainly "keep up" with cross-border developments but also promote them so that confidence, stability and growth are enhanced.

The international standing of IOSCO, and the work that it does, provide assurance that regulation is indeed making a positive contribution to the cross-border growth of securities markets. However, there is no room for complacency and, as I said earlier, we still have a full agenda of work on the table.

IOSCO was set up 23 years ago. Because of its history, its achievements, and the depth and breadth of its membership today, IOSCO is well placed to keep abreast of developments and to provide regulatory leadership in the rapidly globalising marketplace. It is currently providing that leadership on the issues which are of critical importance for securities markets worldwide.

Companies with global reach

The good governance of companies with global reach is increasingly important. None of us take this for granted since Enron, Parmalat and the other high profile corporate collapses of recent years. And of course, those collapses have triggered regulatory action in jurisdictions around the world.

A timely IOSCO task force inquired into these scandals, Parmalat in particular, and reported back a year ago. It concluded that existing principles and standards in the international arena addressed most of the issues exposed by the corporate collapses. The weaknesses were the implementation of those principles and standards and their enforcement, particularly across jurisdictional borders.

The task force said that deliberate fraud and criminal behaviour within companies will always be a risk to their stability and to the prosperity of investors. Lamberto Cardia of Italy, co-chairman of the task force with Commissioner Roel Campos of the SEC, put the central issue in these terms: “Even with high quality regulatory standards, fully implemented and enforced, it will not be possible to totally eliminate financial fraud. It takes constant vigilance by all stakeholders – corporate issuers, investors, analysts, auditors, intermediaries and regulators alike – to minimise market misconduct.”

At the same time, Cardia and Campos saw plenty that regulators could and should be doing to contribute more to such vigilance. Regulators have made moves to tighten requirements for financial reporting, auditor oversight and boardroom accountability, including the passing of the Sarbanes Oxley Act in the US. And IOSCO has adopted a three-part action plan to strengthen markets against fraud. It involves:

- making even greater efforts to encourage member jurisdictions to implement the core principles and various standards;
- strengthening mechanisms for cross-border cooperation on enforcement; and
- working to bring uncooperative and under-regulated jurisdictions into line with international expectations.

Good corporate governance of global companies is an even bigger issue in the context of the international market trends I outlined before. Enron and Parmalat have served as “red flags” for regulators. The responses over the past three years, both through IOSCO and within individual jurisdictions, indicate that regulation is keeping up, and even anticipating, developments and their implications for corporate governance, financial reporting and auditing.

Market practices

Market practices have particular impact on investor confidence. Regulators must always be ready to admit that actual practices may diverge markedly from principles and standards, and even that principles and standards may be poorly conceived and ineffective and need revision. IOSCO actively seeks to identify and address gaps in regulatory coverage, and disparities between regulatory intent and market practice.

Auditor oversight is a good example. In 2002, in an early response to the Enron collapse, IOSCO identified and articulated principles for ensuring the independence of public company external auditors, and the governance structures that are needed to support them. We issued a comprehensive set of principles on auditor oversight that was endorsed by the full membership in 2003.

In 2004, we surveyed practices in 57 member jurisdictions, to assess the progress actually made in the markets, and to identify the structures and processes that were in place. The results were relatively pleasing. IOSCO found its principles were broadly implemented in most jurisdictions. For instance, 82% of those surveyed had one or more formal bodies overseeing auditing processes within public companies.

There were, however, some notable gaps. The IOSCO approach favours the existence of an audit industry body that is independent of the audit profession in terms of funding, staffing and decision making. The survey showed that only 67% of the jurisdictions had an auditor oversight body that was independent from the profession.

Research like this provides a solid platform for IOSCO to promote debate and to encourage individual jurisdictions to come up to international expectations. It is another way in which IOSCO is contributing to improved and consistent regulation of the world's securities markets.

Regulator effectiveness

The regulation of international markets ultimately hinges on the effective work of regulatory bodies at their domestic level and in cooperation with their counterparts across borders. Among IOSCO members there are wide disparities in resources and capacity, disparities that reflect differences, for example, in national economies and legal systems.

IOSCO has long recognised the need to set international benchmarks for regulators to aspire to, and to provide support for them along the way. In 2003, we adopted a formal methodology by which regulators could assess their progress towards full implementation of the core IOSCO principles. And last year, to make it easier to use, the methodology was made available as an electronic template. There is continued determination to provide practical support, particularly expert assistance, for regulators who seek help. The Regional Committees of IOSCO will increasingly become channels for cross border support between regulators who are well placed to share resources and experiences. Training is another evident need, and IOSCO also works effectively in this area.

International cooperation

The need for effective international cooperation on enforcement is obvious. Building mechanisms for greater cooperation is probably the most pressing issue in international securities market regulation at present. Without cooperation, we will certainly see enforcement activity become less and less effective.

IOSCO has addressed this through its Multilateral Memorandum Concerning Consultation and Cooperation and Exchange of Information. The IOSCO MMOU, as it is known, was developed in 2002. In a bold step at last year's annual conference, IOSCO members adopted a new strategic direction which requires all members to become signatories, or be committed to becoming signatories, to this MOU by January 2010.

To date, 30 members have been accepted as signatories. To be accepted as a signatory, a regulator must have the legal capabilities to exchange information and cooperate with other securities regulators in enforcement cases on request, in an efficient and timely manner. Some regulators cannot yet operate at the required level and may need to seek changes to their law to do so. IOSCO offers assistance with this work.

The goal is to have a network of securities regulators worldwide who provide seamless enforcement assistance and implement common regulatory standards. The 2010 deadline is ambitious but we have made a good start. ASIC and the Securities Commission in New Zealand are both signatories, and we have made good use of the IOSCO MMOU over the past two years, both mutually and with other jurisdictions who are signatories.

I would contend that the MOU, and the commitment within IOSCO to rolling out an effective network for cooperation, are further key indicators that regulation is keeping pace with market developments.

So, is regulation really keeping up?

My earlier “yes” answer to this central question was qualified. In this, I am acknowledging that there are inadequacies in today’s regulatory framework, some of which I have touched on earlier. IOSCO has a clear strategic direction, a good grasp on the current issues, and strong support from its constituencies, but the international implementation of principles and standards is still very much work in progress. Indeed, the work of establishing and updating those principles and standards is inevitably an ongoing process.

We have dynamic and fast growing markets worldwide. IOSCO, too, must continue to be a dynamic organisation. That means constantly building and refining regulatory systems that keep pace with and to some extent, facilitate, all major cross border developments. IOSCO, and regulation in general, is keeping up but there is certainly no time to take a breather or to stop asking, “what more needs to be done?”

Is regulation fettering developments?

That brings us to the second question in my title today: “Is regulation fettering developments?” We are regularly told from within the markets that some regulation fetters developments. We hear this, and IOSCO is acutely aware of the dynamic relationship between market developments and regulation. However, effective regulation enhances confidence in the markets and is crucial for strong capital market growth. It is a question of where the balance lies.

There will always be debate around how and where regulation hinders or helps fair competition and the positive growth of markets. From the IOSCO perspective, informed debate is always welcome. It helps us to understand more fully what is happening in the markets and to take steps so that regulation can, indeed, keep up.

IOSCO constantly listens to market participants, monitors trends, and assesses the effectiveness of principles and regulations. International conferences can be extremely useful in this regard. For example, at last October's IOSCO Technical Committee conference in Frankfurt we heard from various business leaders on issues they thought important, including serious impediments to competition in the world's largest capital markets.

Last year, the Executive Committee endorsed a consultation policy and procedures that enables industry bodies, international organisations, market participants and the public to contribute to IOSCO's standard setting process. Not only does this promote transparency, it also contributes to more effective and acceptable principles and standards.

In broad terms, regulation may be faulted if it is poorly designed or implemented, and this can lead to loss of market efficiency. With the current focus on the regulation of financial intermediaries, Gerald Corrigan, the Managing Director of Goldman Sachs and Co., recently put a vigorous case for large, international, integrated financial intermediaries and their contribution to the public good.

Mr Corrigan invited us to look closely at the crucial role his firm and others really play in mobilising and allocating savings throughout the world. These intermediaries need to be large because of the size of the capital flows being handled, and they need to be integrated to meet the complex needs of clients. He called for regulators to fully appreciate these firms, and their management of potential conflicts of interest and large market exposures.

Mr Corrigan's paper reflects the breadth and depth of discussion that occurs as regulatory standards are formulated. and the challenges for regulation globally.

Another ground on which regulation is often challenged in the international marketplace is that the differences between the rules applying in different jurisdictions can unfairly tilt the playing field for competitors. This is a particularly topical issue between the United States and the European Union, the two biggest capital market regions.

In Frankfurt, we heard criticism from the Chief Financial Officer of Siemens (Heinz-Joachim Neuburger) of how US regulation has, in his view, tilted the playing field against EU-based issuers through the prominence of US GAAP and through listing requirements that are more arduous than in Europe. He also flagged another potential issue, that he saw arising from the move to International Financial Reporting Standards, that different interpretations of IFRS may be adopted in different jurisdictions as companies move to IFRS worldwide. Might new regulatory hindrances arise simply from a plethora of different national interpretations?

National differences in regulation can distort market decision making, with losses of competitive potential and market efficiency. Such differences may bring about opportunities for regulatory arbitrage. Can regulatory arbitrage fetter cross border developments? Or can it, on the contrary, pave the way to regulatory efficiency through natural market forces as traditional economic thinking might suggest?

Also in Frankfurt, the President of the Association of German Banks (Klaus-Peter Muller) put a focus on hedge funds, that fast-growing form of financial intermediary that takes special advantage of less stringent regulation in some jurisdictions, particularly so-called “offshore financial centres”. Mr Muller suggested that effective regulation for transparency on hedge fund activities is possible only if opportunities for regulatory arbitrage are denied. In his view, hedge fund regulation must be international.

Another ground for criticism of regulation in the context of international markets relates directly to the work of IOSCO and other international bodies. Some people question the legitimacy of our standards-setting endeavours because we operate at least one step removed from the accountability mechanisms that apply to national regulators. Is IOSCO truly responsive to market and democratic constituencies? Are its principles and standards really enhancing the fairness, efficiency and growth of international markets given that the principle- and standard-setting processes are not constrained by standard accountability mechanisms?

These issues were also aired in Frankfurt in October in an interesting debate that does bear on the ultimate effectiveness of IOSCO’s principles and standards. To me, the position is straight forward. IOSCO’s governing bodies are most definitely accountable to their membership, and we actively seek regular dialogue with market participants.

Greater transparency of IOSCO’s processes is part of our new strategic direction. If we diverge from the organisation’s fundamental goals, or promote regulation that fetters positive market developments, or not do enough to ensure existing regulation does not fetter market development, there are many strong voices ready to say so. And, of course, IOSCO does not implement rules and processes in markets anywhere, that is the responsibility of regulators in their respective jurisdictions after they adopt IOSCO’s principles and standards.

Concluding Comments

I will close by re-emphasising IOSCO’s commitment to keep up with the globalisation of securities markets and indeed, to facilitate this where confidence, stability and economic growth are enhanced. There are strong indications that the organisation is succeeding and providing the international leadership needed by individual regulators worldwide.

In general, I believe that regulation is keeping up with market developments although there are inadequacies in some particular areas. The work of IOSCO is unending.

We need to continue to establish and promote relevant and timely international standards and monitor their implementation. We also need, with some urgency, to expand a robust international network between securities regulators for cooperation on enforcement.

Is regulation fettering developments? There will always be debate on such issues as the design and effectiveness of particular principles and standards; the effects of cross-border differences in regulatory practices and structures; gaps in regulatory coverage; and also on the processes and transparency of international bodies, such as IOSCO.

We welcome the debate and the opportunity to hear well informed and fair argument from all interested parties in the international securities markets.

I firmly believe that capital markets are more attractive to investors and therefore more likely to grow when robust, transparent, national regulators cooperate across borders to enforce securities law.

There is still much work to be done to raise regulatory practices to international standards in all jurisdictions, and to align rules and processes across borders for the growth of fair and efficient markets. But considerable progress is being made, and IOSCO is the key motivator and facilitator of this progress.

///