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"GLOBAL MARKETS, GLOBAL REGULATION"

There has never been a more challenging time to be a securities regulator.

As soon as one makes a definitive statement like that, one immediately wonders whether it stands up to rigorous scrutiny. I guess the time of the 1934 Securities Act in the US must have been quite exciting. And London's Big Bang in 1986 and Black Monday in 1987 kept regulators on their toes. But it really is hard to think of a time when so much change was underway, change which is removing all the old certainties, and changing almost every aspect of the way the business we regulate is done.

Just think, first, of the world of exchanges. All over the world traditional mutual forms of ownership are giving way to profit-seeking commercial ventures. That is an understandable trend, and I do not think that regulators should try to stand in its way. But it does alter the motivations and incentive structures of those who run exchanges, in ways regulators must take into account. In our meetings here we have been sharing experiences of demutualisation and we have been asking ourselves whether the commercial pressures on profit-seeking enterprises will, over time, affect the willingness of those exchanges to commit the resources necessary to fulfil their regulatory and public interest responsibilities.

I will say a little more about my own views on that subject later. But of course if demutualisation is not the only change affecting exchanges, particularly not in Europe, where all the talk is of mergers and alliances. Just two weeks ago the London and Frankfurt stock exchanges announced their intention to merge. In future they will be run by a Scottish chairman and a Swiss chief executive, and will be called iX which, if I remember my schoolboy Latin, is pronounced “nein”. The Exchange will be based in Finanzplatz London, but its newtech brother, NASDAQ Europe, will be based in what we must now know as Mainhattan.

It is not yet clear what the eventual frontiers of this merged entity will be. Madrid and Milan have expressed an interest already, while, for the moment, there seem no talks in prospect with Euronext, the Franco-Belgo-Dutch alliance announced a little earlier.

But, again, if demutualisation and mergers were all we had to worry about, life would be simple. On top of this exchange activity, we also have new trading system competitors coming into being. Indeed some see exchange mergers as a kind of dinosaurs’ mating dance, while new forms of life emerge in the form of electronic crossing networks, active bulletin boards and what have you.

It is too early to say how much of Europe's securities trading will migrate to these new systems. For once it is not possible to look across the Atlantic to the US to see a forecast of future trends in Europe. European exchanges typically have central electronic order books, the absence of which has been a great stimulus to ATS development in North America. But although the volumes of business they transact remain small, a recent survey I conducted for FESCO, the European securities regulators organisation, suggested that there were now a dozen ATSs of one sort or another operating in London, and half a dozen in one or other European centre. And some of these alternative systems have serious financial backing behind them.

In many respects, this must be regarded as a positive development. It is likely to result in more choice for intermediaries and investors, and to result in cheaper trading. This competition ought to be good for the development of the market as a whole. But, again, there are potential downsides for regulators. Is there a risk that liquidity will be fragmented? Is there a risk that two-tier markets will develop, with sophisticated professional investors having access to a range of trading systems offering them different prices from those available to retail investors? What does best execution mean in this new world? Must every broker look at the price on every trading system to satisfy her best execution obligation? Might that not act as a competitive disadvantage for small brokers? These are complex questions for regulators, too.

And Internet based trading systems add yet another dimension of complexity. As we know, the Internet is no respecter of national frontiers. Often it is very difficult to know where a website, or the company owning a website, is actually located. So it is similarly difficult to know at whom its offerings are targeted at. In IOSCO we try to operate a kind of common sensical "directed at" test. But this is easier for some people than for others. I guess that if you see an Internet site in the Greek alphabet offering drachma facilities, you have a pretty reasonable idea that it is targeted at

investors in Melbourne. But if you're in an English language city, it is more difficult. Of course there are certain give-away indicators which tell you if a site is based in Australia. If it opens with "G'day Bruce, fancy a flutter", you have a pretty good idea.

But most of the sites targeted as UK investors are based in hard currency countries like the Cayman Islands, or other Caribbean centres. They raise particular difficulties for regulators in major onshore centres.

All these changes affect, one way or another, the delivery mechanisms for securities. But there is more. All this is happening at a time of unprecedented volatility in stock prices, driven in part by the behaviour of new economy stocks. That, again, is a topic which has preoccupied a number of us over the last few days. I think we understand some of the reasons for this increased volatility. New economy stocks come to the market rather earlier than was traditionally the case, meaning that their valuations are inevitably more speculative, based more on expectation than on a solid earnings record. Not so much a P/E ratio, but a P/D ratio, where the D stands for dream.

Whatever the reason, we have seen our major markets moving up and down dramatically, sometimes by five or ten per cent in a day. In one sense, that is something which a regulator can watch with some indifference. And at times like that one is quite happy to have an in-house rule banning investments in individual stocks! But volatility places pressure on some of the protective mechanisms in the market place, on stop loss orders in exchanges themselves, perhaps. Perhaps more importantly it can affect the position of individual investors, particularly those trading on margin, or trading at the limit of their financial resources. These potential risks for investors worry us a lot. And they worry us particularly in London where we have seen a massive increase in the number of individual small investors accessing the exchange directly, over the last few months. There was a step change in interest in

equity investing some time around November of last year, which has continued ever since.

We do not have a particularly good understanding of why there should have been such a sudden jump. But we do know that there is a growing trend towards an expansion of equity holding across the population. And we know that an ageing population in most developed countries is creating new types of market, new types of investor, and indeed new types of risk.

Certainly in the United Kingdom we can see that the gradual withdrawal of the state from 'cradle to grave' welfare provision is causing more and more people to make provision for their own retirement. And if you map that change against a very fast moving labour market, where many people are in and out of jobs throughout their working lives, and therefore need more flexible pension provision than was the case in the past, you can see quite a combustible mixture, which needs particular care in regulation.

This is an area where in the UK we can offer some cautionary tales, particularly in the form of personal pensions mis-selling scandal, where we are engaged in a mop-up operation which probably amounts to the largest ever scheme of consumer compensation paid by the financial sector. When the process is complete it is likely that some 2-3 million investors will have received compensation totalling somewhere north of £11bn, which is quite a lot of money in anyone's language, and at the present exchange rate it must be somewhere close to Australia's GDP.

The underlying lesson of that sad episode is that product complexity, and the silken tongues of salesmen, well exceeded the ability of unsophisticated investors to understand the risks of the products they were taking up. And that is a lesson of very general application. On the one hand we have more and more individuals seeking to make direct savings provision, and quite reasonably wanting to take advantage of the

more exciting returns available in equity related products, rather than putting their money in a building society or a savings and loan. Yet on the other hand their financial understanding does not match the standard needed to be able to find one's way through a maze of competing products, often of great complexity. Indeed products which often seem designed expressly to be complicated and confusing.

This is becoming a lengthy catalogue of problems. And indeed perhaps regulators are naturally more talented at identifying problems than developing imaginative solutions to them. But our regulatory reform programme in the United Kingdom has given us a great opportunity to revise our system of financial regulation from scratch, and the construction of the FSA, on quite a considerable scale in regulatory terms – over 2,000 staff and a budget of around £170mn – has given us an exciting opportunity to think in quite fundamental terms about what kind of regulator we want to be, and how we should organise ourselves to be able to cope with these new problems, in the new world.

So what do we think regulators need to do in this new economy, to address these new challenges?

We have written a book or two on this subject in London over the last couple of years. Indeed we have issued some 45 consultation papers, putting together different elements of our new régime. So I thought the most useful thing I could do this morning would be to spend ten minutes or so on each of them, giving you a snapshot of our exciting new régime.

Or, instead, by popular demand, I will try to summarise the lessons in the form of a very short list of guiding principles, which we hope will carry us through the treacherous waters I have tried to chart.

There are seven principles which I propose to you today.

The first, which may seem counterintuitive after everything I have said about change, is that a regulator needs to stick to tried and tested objectives. In other words, the basic raisons d'être of regulation, market confidence and consumer protection, are not changed by new trading systems or delivery mechanisms. If it is right, for example, that an investor should be given certain forms of information, allowed a cooling off period, told what the underlying costs of a transaction are when this is done on paper, then it must be right for a transaction in cyber space, too. The regulatory delivery mechanism may change, in parallel with the change in investment delivery. But the underlying value system remains the same.

Our second guiding light is that a regulator today must be forward looking. We must always be looking for trouble ahead. The past is another country, to coin a phrase, and we simply have to use analytical tools to think through the way in which changing economic incentives will affect the environment for investors.

And that analysis should be undertaken with an eye to our third principle, that regulation needs to be rigorously risk-based. We now benefit in London from having been given, by Parliament, a set of statutory objectives which we can use to orient all our activity. We must promote market confidence. We must protect consumers of financial services, bearing in mind our own responsibilities to make decisions for themselves, we must promote public understanding of the financial system and we must work to reduce financial crime.

There is almost an unlimited amount of work which a regulator could do in pursuit of these objectives, so we need rigorously to prioritise. And we can only do that if we have a developed risk-based approach to regulation. That is what we are investing heavily in at the moment, and looking at risks not just at the level of the individual institution, but emerging risks in markets as a whole. The product complexity risk, for example, is one we have identified. And as a major effort to counter that we are

producing product league tables which will allow consumers to compare and contrast different product offerings. In other words we will be seeking directly to counteract the information asymmetry in the market place, by guiding people through the forest of sometime confusing data offered by product providers and advisers.

And that initiative itself incorporates my fourth principle, which is that regulators must speak directly to investors. That is something which the SEC, particularly under Arthur Levitt's leadership, has been doing for some time. And we have shamelessly copied some of their initiatives. I know that ASIC, here, has done the same, and indeed we borrowed a former member of Alan Cameron's staff to help get our initiative moving in the UK. But we are now at the point where we are doing some new things ourselves, of which product league tables is one. And it is absolutely clear to me that we need to orient far more of our work towards the individual saver and investor, if we are to be effective. This is absolutely necessary to counteract this understanding gap, this information gap, which is particularly visible in our markets today.

Our fifth principle is flexibility. The market is changing so fast that we must be ready to change with it. We cannot afford to believe that our current allocation of staff to particular tasks, or the current boundaries between regulators and exchanges, are sacrosanct. To give you one particular example, the demutualisation of exchanges, and the growing competition between them, may well affect the amount of regulation which it is right to expect an exchange to take on.

In London, for example, we have reached the conclusion that one exchange, which is competing with others, should not be the national listing authority. That function transferred to us, along with its staff, on 1 May. I have to say I feel more comfortable now with that responsibility in-house, particularly when there are considerable pressures to relax listing standards to take account of the particular circumstances of

new economy stocks. I am not saying that no change in listing requirements is possible. Indeed we have made some changes in the UK. But my personal view is that the public interest arguments can be better weighed by statutory regulators in this new environment, than by a profit-seeking exchange. And I am encouraged in that view by the fact that the London Stock Exchange itself reached the same conclusion.

I think we shall all need to be vigilant in this area, and it may be that there are other aspects of regulation which will need in future to be undertaken by statutory regulators, rather than by SROs. I am sure the appropriate balance will be different from country to country. The traditions are different, and the flexibility of the legislative environment is often rather different from place to place. But my key point is that we would be well advised to keep an open mind about where these boundaries lie in the future.

My sixth and penultimate point is that regulators will need to be even more international in their outlook in the future, and will be bound to place more reliance on each other. There is no possible way, in this new environment, of hoping to police all investment activity on a host-state basis. How does one hope to impose one's own conduct of business requirements on a website based in another jurisdiction? In Europe, we will face a particular version of this problem as exchanges consolidate, and as the trading in the stocks of a particular country is increasingly undertaken outside its boundaries. There will be a need for much better developed regulatory collaboration across borders and, as I say, much more mutual reliance. There are those who argue for a pan-European, or even a global regulator. That would require a much greater pooling of sovereignty, and greater commonality in legal systems than is currently evident, or planned. So the practical approach now must be built on collaboration. Conferences like this one help us to build the confidence in each other that we need.

My last, seventh point is of a slightly different character to the others. My interpretation of this new and more flexible world suggests that firms, intermediaries and investors will have far more choice about how and where they transact their business than they have had in the past. If they wish to deal through an unregulated broker, in a weakly regulated offshore centre, and buy into a wholly unregulated investment fund, for example, and they are free to do so. Of course high net worth individuals have always been free to do that, but that freedom will now in practice be extended to a much larger proportion of the population.

We as regulators may think that it would be highly unwise for many of these investors to manage their finances in that way. That they are exposing themselves to unreasonable levels of risk, and they will live to regret it. We may well think that, and we may well be right. But one thing we will no longer be able to do is to legislate and regulate in such a way that we impose that judgment on investors. It just will not be possible in a web-based world.

So regulators will themselves be, in a sense, in a competitive market place. We will need to demonstrate that the régime we offer is worth paying for, that it offers value for money. The product we offer is a complicated combination of some assurance of prudential soundness, some assurance that information provided to you is fair and honest, that there are certain protections built into the system like cooling off periods, or whatever, that there is a regulator to resolve disputes, perhaps, a compensation scheme and, in our case certainly, a robust complaints mechanism.

That package costs money. We don't think the costs are exorbitant in our case, but who am I to say? I suspect that in future, however, we will know the answer to that question. Because people will either choose to undertake their business in our régime, or they will move to another better régime, which offers a better balance of costs and benefits, or indeed to no régime at all.

We regulators will come under ever increasing pressure to show that the package we offer to investors is worth paying for. My own view is that the package we currently offer in London is worth paying for, and indeed the evidence of business volumes transacted through London, and the number of applications for new authorisations we have in the pipeline, suggest that the balance of cost and flexibility we are offering is reasonably attractive to a lot of businesses, and a lot of investors. But I am quite clear that we cannot rely on that remaining the case in future, and that we have to get ourselves into a mindset where we recognise that firms and their investors have a choice.

Perhaps, soon, our helpline phones will say "thank you for choosing to be authorised by the FSA, or another member of the one world regulatory alliance". And our disciplinary committee chairmen will end their sessions by saying "we hope to see you again in our tribunals very soon".

I exaggerate, perhaps, to make a point. But I think it is, nonetheless, a serious one.