Objectives and Principles of Securities Regulation

International Organization of Securities Commissions

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Foreword and Executive Summary

This document sets out 30 principles of securities[1] regulation, which are based upon three objectives of securities regulation. These are:

- **The protection of investors;**[2]
- **Ensuring that markets are fair, efficient and transparent;**
- **The reduction of systemic risk.**

The 30 principles need to be practically implemented under the relevant legal framework to achieve the objectives of regulation described above. The principles are grouped into eight categories.

A. Principles Relating to the Regulator

1 The responsibilities of the regulator should be clear and objectively stated.

2 The regulator should be operationally independent and accountable in the exercise of its functions and powers

3 The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.

4 The regulator should adopt clear and consistent regulatory processes.

5 The staff of the regulator should observe the highest professional standards including appropriate standards of confidentiality.

B. Principles for Self-Regulation

6 The regulatory regime should make appropriate use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, to the extent appropriate to the size and complexity of the markets.

7 SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.

C. Principles for the Enforcement of Securities Regulation

8 The regulator should have comprehensive inspection, investigation and surveillance powers.

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[1] For convenience, in this document, the words "securities markets" are used, where the context permits, to refer compendiously to the various market sectors. In particular, where the context permits they should be understood to include reference to the derivatives markets. The same applies to the use of the words "securities regulation." (*See* IOSCO By-Laws, Explanatory Memorandum).

[2] The term "investor" is intended to include customers or other consumers of financial services.

9 The regulator should have comprehensive enforcement powers.

10 The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.

D. Principles for Cooperation in Regulation

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.

E. Principles for Issuers

14 There should be full, timely and accurate disclosure of financial results and other information that is material to investors' decisions.

15 Holders of securities in a company should be treated in a fair and equitable manner.

16 Accounting and auditing standards should be of a high and internationally acceptable quality.

F. Principles for Collective Investment Schemes

17 The regulatory system should set standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme.

18 The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.

19 Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.

20 Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme.

G. Principles for Market Intermediaries

21 Regulation should provide for minimum entry standards for market intermediaries.

22 There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.

23 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.

24 There should be procedures for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.

H. Principles for the Secondary Market

25 The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight.

26 There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.

27 Regulation should promote transparency of trading.

28 Regulation should be designed to detect and deter manipulation and other unfair trading practices.

29 Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.

30 Systems for clearing and settlement of securities transactions should be subject to regulatory oversight, and designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.

Table of Contents

Part I - Introduction and Statement of Objectives and Principles

1. Introduction

This document sets out three objectives upon which securities regulation is based. Although there are local differences in market structures, these objectives form a basis for an effective system of securities regulation.

The document also sets out thirty principles of securities regulation that give practical effect to the objectives. The discussion provides some examples of current practices, recognizing that these practices will and should change as the markets change and as technology and improved coordination among regulators makes other strategies available.

The securities and derivatives markets are vital to the growth, development and strength of market economies. They support corporate initiatives, finance the exploitation of new ideas and facilitate the management of financial risk. Further, since retail investors are placing an increasing proportion of their money in mutual funds and other collective investments, securities markets have become central to individual wealth and retirement planning.

Sound and effective regulation and, in turn, the confidence it brings is important for the integrity, growth and development of securities markets.[3]

IOSCO is the leading international grouping of securities market regulators. Its current membership comprises regulatory bodies from [insert current number] countries who have day-to-day responsibility for securities regulation and the administration of securities laws.

The Preamble to IOSCO's By-Laws states:

> Securities authorities resolve to cooperate together to ensure a better regulation of the markets, on the domestic as well as on the international level, in order to maintain just, efficient and sound markets:
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> - to exchange information on their respective experiences in order to promote the development of domestic markets;
> - to unite their efforts to establish standards and an effective surveillance of international securities transactions;
> - to provide mutual assistance to ensure the integrity of the markets by a vigorous application of the standards and by effective enforcement against offences.

IOSCO recognizes that sound domestic markets are necessary to the strength of a developed domestic economy and that domestic securities markets are increasingly being integrated into a global market.

The IOSCO By-Laws also express the intent that securities regulators, at both the domestic and international levels, should be guided by a constant concern for investor protection.

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[3] IOSCO Public Document No. 95, *Measures to Disseminate Stock Property*, IOSCO Emerging Markets Committee, May 1999.

The international regulatory community should provide advice, and a yardstick against which progress towards effective regulation can be measured. This document further evidences IOSCO's commitment to the establishment and maintenance of consistently high regulatory standards for the securities industry. As the leading international grouping of securities regulators, IOSCO accepts responsibility for helping to establish the high standards for regulation.

Consistently high regulatory standards and effective international cooperation will not only protect investors but also reduce systemic risk.

Regulators should be prepared to address the significant challenges posed by the increasing importance of technology and particularly developments in the area of electronic commerce.

Increasingly globalized and integrated financial markets pose significant challenges to the regulation of securities markets. At the same time, markets, particularly some emerging markets which have seen much growth in recent years, have been prone to effects of cross-border and cross-asset interactions, and some also are susceptible to higher short term volatilities after economic shocks or during periods of great uncertainty. Therefore, in a global and integrated environment regulators must be in a position to assess the nature of cross-border conduct if they are to ensure the existence of fair, efficient and transparent markets.

An increasingly global market place also brings with it the increasing interdependence of regulators. There must be strong links between regulators and a capacity to give effect to those links. Regulators must also have confidence in one another. Development of these linkages and this confidence will be assisted by the development of a common set of guiding principles and shared regulatory objectives.

Many of the topics addressed in this document are already the subject of IOSCO reports or Resolutions.[4] The reports published by IOSCO and the Resolutions adopted by its membership are also a valuable source of information on the principles that underlie effective securities regulation and the tools and techniques necessary to give effect to those principles. This document draws upon those reports as a primary source. IOSCO's reports generally provide a more detailed treatment of the particular topic. Reference is made to those reports and resolutions in the notes to this document and they should be consulted when considering particular topics.

[4] A full list of IOSCO Public Documents and Resolutions is published in the IOSCO´s Web Site: www.iosco.org

2. Implementation

IOSCO members through their endorsement of this document express their commitment to the objectives and principles it sets out. Insofar as it is within their authority, they intend to use their best endeavors within their jurisdiction to ensure adherence to those principles. To the extent that current legislation, policy or regulatory arrangements may impede adherence to these principles, they intend that changes should be sought.[5]

There is often no single correct approach to a regulatory issue. Legislation and regulatory structures vary between jurisdictions and reflect local market conditions and historical development. The particular manner in which a jurisdiction implements the objectives and principles described in this document must have regard to the entire domestic context, including the relevant legal and commercial framework.

Depending upon the matter in question and the arrangements within a particular jurisdiction, implementation may require any or all of: a change in legislation or regulation; a change in policy or practice by the regulatory authority; or a bilateral or multilateral agreement.

The regulator should frequently review the particular way in which securities regulation is carried out in its market. This document is not exhaustive in its treatment of all areas of market activity, the markets themselves are in a constant state of development and the content of regulation must also change if it is to facilitate and properly regulate those changing markets.[6] The means to give effect to the principles described in this document should, therefore, be expected to change over time.

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5 *See* IOSCO Resolution No. 41: *Resolution on IOSCO Adoption of the Objectives and Principles of Securities Regulation* (P.C.), September 1998:

6 *See* IOSCO Public Document No. 83, *Securities Activity on the Internet*, IOSCO Technical Committee, September 1998, IOSCO Public Document No. 120, *Securities Activity on the Internet II*, IOSCO Technical Committee, June 2001 and IOSCO Public Document No. 159, *Report on Securities Activity on the Internet III*, IOSCO Technical Committee, October 2003.

3. Structure of the Document

The paper is divided into three parts.

Part I provides an introduction to the paper and a statement of the objectives and the principles of securities regulation. There is a brief discussion of each of the objectives.

Part II describes the desirable attributes of a regulator and the potential role of self-regulatory organizations. It also considers the enforcement and market oversight work of the regulator and the need for close cooperation between regulators.

Part III considers the practical implications of the objectives in securities regulation with particular reference to issuers, collective investment schemes, market intermediaries, secondary trading and the clearance and settlement of transactions.

Each substantive section in Parts II and III includes a boxed subsection that provides a summary list of the principles to be addressed in giving effect to the objectives.

4. Objectives of Securities Regulation

4.1. Objectives of Securities Regulation

The three core objectives of securities regulation are:

- **The protection of investors;**
- **Ensuring that markets are fair, efficient and transparent**;
- **The reduction of systemic risk.**

4.2. Discussion of the Objectives

The three objectives are closely related and, in some respects, overlap. Many of the requirements that help to ensure fair, efficient and transparent markets also provide investor protection and help to reduce systemic risk. Similarly, many of the measures that reduce systemic risk provide protection for investors.

Further, matters such as thorough surveillance and compliance programs, effective enforcement and close cooperation with other regulators are necessary to give effect to all three objectives.

The aforementioned objectives of regulation are further described below. In Parts II and III of the document the means to satisfy these objectives, articulated in 30 principles, are explored in greater detail in the context of actual market structures and arrangements.

4.2.1. The Protection of Investors

Investors should be protected from misleading, manipulative or fraudulent practices, including insider trading, front running or trading ahead of customers and the misuse of client assets.

Full disclosure of information material to investors' decisions is the most important means for ensuring investor protection. Investors are, thereby, better able to assess the potential risks and rewards of their investments and, thus, to protect their own interests. As key components of disclosure requirements, accounting and auditing standards should be in place and they should be of a high and internationally acceptable quality.

Only duly licensed or authorized persons should be permitted to hold themselves out to the public as providing investment services, for example, as market intermediaries or the operators of exchanges. Initial and ongoing capital requirements imposed upon those license holders and authorized persons should be designed to achieve an environment in which a securities firm can meet the current demands of its counter parties and, if necessary, wind down its business without loss to its customers.

Supervision of market intermediaries should achieve investor protection by setting minimum standards for market participants. Investors should be treated in a just and equitable manner by market intermediaries according to standards which should be set out in rules of business conduct. There should be a comprehensive system of inspection, surveillance and compliance programs.

Investors in the securities markets are particularly vulnerable to misconduct by intermediaries and others, but the capacity of individual investors to take action may be limited. Further, the complex character of securities transactions and of fraudulent schemes requires strong enforcement of securities laws. Where a breach of law does occur, investors should be protected through the strong enforcement of the law.

Investors should have access to a neutral mechanism (such as courts or other mechanisms of dispute resolution) or means of redress and compensation for improper behavior.

Effective supervision and enforcement depend upon close cooperation between regulators at the domestic and international levels.

4.2.2. Ensuring that Markets are Fair, Efficient, and Transparent

The regulator's approval of exchange and trading system operators and of trading rules helps to ensure fair markets.

The fairness of the markets is closely linked to investor protection and, in particular, to the prevention of improper trading practices. Market structures should not unduly favor some market users over others. Regulation should detect, deter and penalize market manipulation and other unfair trading practices.

Regulation should aim to ensure that investors are given fair access to market facilities and market or price information. Regulation should also promote market practices that ensure fair treatment of orders and a price formation process that is reliable.

In an efficient market, the dissemination of relevant information is timely and widespread and is reflected in the price formation process. Regulation should promote market efficiency.

Transparency may be defined as the degree to which information about trading (both for pre-trade and post-trade information) is made publicly available on a real-time basis. Pre-trade information concerns the posting of firm bids and offers as a means to enable investors to know, with some degree of certainty, whether and at what prices they can deal. Post-trade information is related to the prices and the volume of all individual transactions actually concluded. Regulation should ensure the highest levels of transparency.

4.2.3. The Reduction of Systemic Risk

Although regulators cannot be expected to prevent the financial failure of market intermediaries, regulation should aim to reduce the risk of failure (including through capital and internal control requirements).[7] Where financial failure nonetheless does occur, regulation should seek to reduce the impact of that failure, and, in particular, attempt to isolate the risk to the failing institution.[8]

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[7] *See* IOSCO Public Document No. 80, *Causes, Effects And Regulatory Implications Of Financial and Economic Turbulence in Emerging Markets - Interim Report*, IOSCO Emerging Markets Committee, September 1998, and IOSCO Public Document No. 99, *Causes, Effects and Regulatory Implications of Financial and Economic Turbulence in Emerging Markets*, IOSCO Emerging Markets Committee, November 1999.

[8] *See* IOSCO Public Document No. 98, *Hedge Funds and Other Highly Leveraged Institutions*, IOSCO Technical Committee, November 1999.

Market intermediaries should, therefore, be subject to adequate and ongoing capital and other prudential requirements. If necessary, an intermediary should be able to wind down its business without loss to its customers and counterparties or systemic damage.

Risk taking is essential to an active market and regulation should not unnecessarily stifle legitimate risk taking. Rather, regulators should promote and allow for the effective management of risk and ensure that capital and other prudential requirements are sufficient to address appropriate risk taking, allow the absorption of some losses and check excessive risk taking. An efficient and accurate clearing and settlement process that is properly supervised and utilizes effective risk management tools is essential.

There must be effective and legally secure arrangements for default handling. This is a matter that extends beyond securities law to the insolvency provisions of a jurisdiction.

Instability may result from events in another jurisdiction or occur across several jurisdictions, so regulators' responses to market disruptions should seek to facilitate stability domestically and globally through cooperation and information sharing.

5. The Regulatory Environment

Implicit throughout this document is the belief that regulation should facilitate capital formation and economic growth. In the context of regulation, there should also be a recognition of the benefits of competition in the market place.

Regulation is necessary to ensure the achievement of the three core objectives. Nevertheless, inappropriate regulation can impose an unjustified burden on the market and inhibit market growth and development.

It is possible to identify general attributes of effective regulation that are consistent with sound economic growth:

- there should be no unnecessary barriers to entry and exit from markets and products;
- the markets should be open to the widest range of participants who meet the specified entry criteria;
- in the development of policy, regulatory bodies should consider the impact of the requirements imposed;
- there should be an equal regulatory burden on all who make a particular financial commitment or promise.

More generally, there must be an appropriate and effective legal, tax and accounting framework within which the securities markets can operate. Securities law and regulation cannot exist in isolation from the other laws and the accounting requirements of a jurisdiction.

Matters of particular importance in the legal framework are set out in Annexure 3. This Annexure is not intended to be an exhaustive list of matters to be addressed in domestic legislation but rather to identify some matters that particularly impact upon the securities markets.[9]

The accounting framework may also be considered an aspect of the legal framework but it (particularly the preparation of financial statements) is discussed in the context of disclosure by issuers in Section 10.

[9] In addition, sound corporate governance practices are an important additional protection of the interests of shareholders. Corporate governance is generally addressed through statute or exchange listing rules or code of practice, the details of which are outside the scope of this document (see also Annex III). *See also* the Organization for Economic Cooperation and Development's *OECD Principles of Corporate Governance* at http://www.oecd.org/pdf/M00008000/M00008299.pdf. *See also* IOSCO Resolution No. 47: Resolution on Corporate Governance (E.C.), May 2002.

Part II - The Regulator

Part II describes the desirable attributes of a regulator[10] and the potential role of self-regulatory organizations, the enforcement and compliance work of the regulator and the need for close cooperation between regulators.

6. The Regulator

6.1. Principles Relating to the Regulator

1 The responsibilities of the regulator should be clear and objectively stated.

2 The regulator should be operationally independent and accountable in the exercise of its functions and powers.

3 The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.

4 The regulator should adopt clear and consistent regulatory processes.

5 The staff of the regulator should observe the highest professional standards, including appropriate standards of confidentiality.

6.2. Clear Responsibility[11]

The capacity of the regulator to act responsibly, fairly and effectively will be assisted by:

- a clear definition of responsibilities, preferably set out by law;
- strong cooperation among responsible authorities,[12] through appropriate channels;
- adequate legal protection for regulators and their staff acting in the bona fide discharge of their functions and powers.

The packaging of products and services may be such that a single product or service exhibits characteristics traditionally associated with at least two of the following: securities, banking and insurance. Legislation should be designed to ensure that any division of responsibility avoids gaps or inequities in regulation. Where there is a division of regulatory responsibilities, substantially the same type of conduct generally should not be subject to inconsistent regulatory requirements.

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[10] In this document, the term "regulator" is used compendiously. There need not be a single regulator. In many jurisdictions, the desirable attributes of the regulator described in this document are in fact the shared responsibility of two or more government or quasi-government agencies.

[11] *See* IOSCO Resolution No. 1: *Resolution on the Regulation of Securities Markets* (P.C.), April 1983.

[12] Here the term "responsible authorities" encompasses those who are responsible for aspects of securities regulation and other law enforcement governmental and regulatory bodies.

6.3. Independence and Accountability

The regulator should be operationally independent from external political or commercial interference in the exercise of its functions and powers and accountable in the use of its powers and resources.

Independence will be enhanced by a stable source of funding for the regulator.

In some jurisdictions, particular matters of regulatory policy require consultation with, or even approval by, a government, minister or other authority. The circumstances in which such consultation or approval is required or permitted should be clear and the process sufficiently transparent or subject to review to safeguard its integrity. Generally, it is not appropriate for these circumstances to include decision making on day-to-day technical matters.

Accountability implies:

- a regulator that operates independently of sectoral interests;
- a system of public accountability of the regulator;
- a system permitting judicial review of decisions of the regulator.

Where accountability is through the government or some other external agency, the confidential and commercially sensitive nature of much of the information in the possession of the regulator must be respected. Safeguards must be in place to protect such information from inappropriate use or disclosure.

6.4. Adequate Powers and Proper Resources

The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.

What this means in practical terms is the subject of elaboration in this document. It includes powers of licensing, supervision, inspection, investigation and enforcement, all of which are discussed in later sections.

It necessarily requires adequate funding for the regulator in order to enable the regulator to exercise its tasks. The level of resourcing should recognize the difficulty of retaining experienced staff who have skills that are valuable to the private sector.

The regulator must ensure that its staff receives ongoing training as required.

6.5. Clear and Consistent Regulatory Processes

In exercising its powers and discharging its functions, the regulator should adopt processes which are:

- consistently applied;
- comprehensible;
- transparent to the public;
- fair and equitable.

In the formulation of policy, the regulator should:

- have a process for consultation with the public including those who may be affected by the policy;
- publicly disclose its policies in important operational areas[13];
- observe standards of procedural fairness;
- have regard to the cost of compliance with the regulation.

Many regulators have authority to publish reports on the outcome of investigations or inquiries, particularly where publication would provide useful guidance to market participants and their advisers. Any publication of a report must be consistent with the rights of an individual to a fair hearing and the protection of personal data, factors that will often preclude publicity when a matter is still the subject of investigation.

Regulators should also play an active role in the education of investors and other participants in capital markets.[14]

6.6. The Conduct of Staff

Staff of the regulator should observe the highest professional standards and be given clear guidance on conduct matters including:

- the avoidance of conflicts of interest (including the conditions under which staff may trade in securities);
- the appropriate use of information obtained in the course of the exercise of powers and the discharge of duty;
- the proper observance of confidentiality and secrecy provisions and the protection of personal data;
- the observance of procedural fairness.

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[13] In some operational areas, and in some cases, particularly in the areas of surveillance and enforcement, consultation and disclosure may be unnecessary or inappropriate as it may compromise the effective implementation of the policy.

[14] *See* IOSCO Public Document No. 83, *Securities Activity on the Internet*, IOSCO Technical Committee, September 1998 (in particular, Key Recommendations 17 - 20 and text), IOSCO Public Document No. 120, *Securities Activity on the Internet II*, IOSCO Technical Committee, June 2001 and IOSCO Public Document No. 159, *Report on Securities Activity on the Internet III*, IOSCO Technical Committee, October 2003.

7. Self-Regulation[15]

7.1. Principles for Self-Regulation

6 The regulatory regime should make appropriate use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence and to the extent appropriate to the size and complexity of the markets.

7 SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.

7.2. The Role of SROs

SROs can be a valuable complement to the regulator in achieving the objectives of securities regulation.[16]

Various models of self-regulation exist and the extent to which self-regulation is used varies. The common characteristics of SROs, in most jurisdictions are a separation from the government regulator (although government oversight and authorization generally exists), and the participation of business, industry and, if appropriate, investors in the operations of the SRO.

There can be substantial benefits from self-regulation:

- SROs may require the observance of ethical standards which go beyond government regulations;
- SROs may offer considerable depth and expertise regarding market operations and practices, and may be able to respond more quickly and flexibly than the government authority to changing market conditions.

SROs should undertake those regulatory responsibilities which they have incentives to perform most efficiently. The actions of SROs will often be limited by applicable contracts and rules.

7.3. Authorization and Oversight

The regulator should require an SRO to meet appropriate standards before allowing the organization to exercise its authority. Oversight of the SRO should be ongoing.

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[15] IOSCO Public Document No. 53, *Legal and Regulatory Framework for Exchange Traded Derivatives*, IOSCO Emerging Markets Committee, June 1996 at pp. 6-9 , *Principles of Effective Market Oversight*, Council of Securities Regulators of the Americas, May 1995 at http://www.cvm.gov.br/ingl/inter/cosra/inter.asp., IOSCO Public Document No. 200, *Exchange Demutualization in Emerging Markets*, IOSCO Emerging Markets Committee, April 2005 and IOSCO Public Document No. 225, *Regulatory Issues Arising from Exchange Evolution*, IOSCO Technical Committee, November 2006.

[16] *See generally*, IOSCO Public Document No. 110, *Model for Effective Self-Regulation*, IOSCO SRO Consultative Committee, May 2000.

Moreover, once the SRO is operating, the regulator should assure itself that the exercise of this power is in the public interest, and results in fair and consistent enforcement of applicable securities laws, regulations and appropriate SRO rules.

The effectiveness of an SRO may be compromised due to conflicts of interest. The regulator should monitor and address the potential that may arise for conflict of interest. The regulator must ensure that no conflict of interest arises because of the SRO's access to valuable information about market participants (whether or not they are members of the SRO itself). The risk of conflict arising may be acute when the SRO is responsible both for the supervision of its members and the regulation of a market sector. [17]

As a condition to authorization, the legislation or the regulator should require an SRO to:

- have the capacity to carry out the purposes of governing laws, regulations and SRO rules, and to enforce compliance by its members and associated persons with those laws, regulations, and rules;
- treat all members of the SRO and applicants for membership in a fair and consistent manner;
- develop rules that are designed to set standards of behavior for its members and to promote investor' protection;
- submit to the regulator its rules for review and / or approval as the regulator deems appropriate, and ensure that the rules of the SRO are consistent with the public policy directives established by the regulator;
- cooperate with the regulator and other SROs to investigate and enforce applicable laws and regulations;
- enforce its own rules and impose appropriate sanctions for non-compliance;
- assure a fair representation of members in selection of its directors and administration of its affairs;
- avoid rules that may create uncompetitive situations; and
- avoid using the oversight role to allow any market participant unfairly to gain advantage in the market.

Regardless of the extent to which self-regulation is used, the government regulator should retain the authority to inquire into matters affecting investors or the market. Where the powers of an SRO are inadequate for inquiring into or addressing particular misconduct or where a conflict of interest necessitates it, the regulator should take over the responsibility for an inquiry from an SRO. It is important, therefore, to ensure that the information provided by the SRO to the regulator allows these matters to be identified at an early stage.

SRO's should follow similar professional standards of behavior on matters such as confidentiality and procedural fairness as would be expected of the regulator.[18]

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[17] *Principles of Effective Market Oversight,* Council of Securities Regulators of the Americas, May 1995 at http://www.cvm.gov.br/ingl/inter/cosra/inter.asp; IOSCO Public Document No. 119, *Issues Paper on Exchange Demutualization*, IOSCO Technical Committee, June 2001.

[18] SROs are generally non-governmental agencies and so will not always be subject to the same standards as apply to a government agency.

8. Enforcement of Securities Regulation

8.1. Principles for the Enforcement of Securities Regulation

8 The regulator should have comprehensive inspection, investigation and surveillance powers.

9 The regulator should have comprehensive enforcement powers.

10 The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.

8.2. Inspection and Compliance Programs[19]

Supervision of market intermediaries' conduct through inspection and surveillance helps to ensure the maintenance of high standards and the protection of investors. These preventative programs are a necessary complement to investigation and enforcement programs.

The regulator should have the power to require the provision of information[20] or to carry out inspections of business operations[21] whenever it believes it necessary to ensure compliance with relevant standards. The suspicion of a breach of law should not be a necessary prerequisite to use of inspection powers in respect of authorized or licensed persons.

Inspections may be carried out by the regulator itself or another competent authority. Alternatively, the regulator might consider delegating such authority to SROs or using third parties, properly supervised, to carry out some of this inspection work on its behalf. These third parties should also be subject to disclosure and confidentiality requirements. Such inspections must be carried out with adequate instruments and techniques, and these may vary between jurisdictions.

In some areas, for example the scrutiny of trading on an exchange, the use of technology will be necessary for effective regulation.[22] In other areas, including the inspection of broker conduct, consideration needs to be given to the balance between on-site inspection and interview and the requirement to provide information from time to time which can be reviewed off-site.

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19 *See* IOSCO Resolution No. 9: *Resolution on Cooperation in Matters of Surveillance and Enforcement* (P.C.), September 1987; IOSCO Resolution No. 39: *Resolution on Enforcement Powers* (P.C.), November 1997; and IOSCO Resolution No. 40: *Resolution on Principles for Record Keeping, Collection of Information, Enforcement Powers and Mutual Cooperation to Improve the Enforcement of Securities and Futures Laws* (P.C.), November 1997.

20 Here the information to be provided may include records kept in the ordinary course of business, information prepared in response to a particular inquiry or as part of a regulator reporting cycle.

21 See IOSCO Public Document No. 184, *Outsourcing in Financial Services,* Joint Forum, February 2005.

22 Exchanges can play an important surveillance role. *See* IOSCO Public Document No. 103, *Investigating and Prosecuting Market Manipulation,* IOSCO Technical Committee, May 2000.

Inspection visits may be rotational or driven by risk assessment or complaint. In making decisions on the efficient use of resources, the regulator must consider both the need for wide market coverage and the importance of adequate inspection in areas of high risk to investors or which threaten systemic stability.

8.3. Comprehensive Enforcement Powers[23]

The complex character of securities transactions and the sophistication of fraudulent schemes require strong and rigorous enforcement of securities laws. Investors in the securities markets are particularly vulnerable to misconduct by intermediaries and others.

The regulator or other competent government authority should, therefore, be provided with comprehensive investigatory and enforcement powers including:

- regulatory and investigative powers to obtain data, information, documents statements and records from persons involved in the relevant conduct or who may have information relevant to the inquiry;
- power to seek orders and/or to take other action to ensure compliance with these regulatory, administrative and investigation powers;
- power to impose administrative sanctions and / or to seek orders from courts or tribunals;
- power to initiate or to refer matters for criminal prosecution;
- power to order the suspension of trading in securities or to take other appropriate action;[24]
- where enforcement action is able to be taken, the power to enter into enforceable settlements and to accept binding undertakings.

As a general matter, these enforcement powers should not compromise private rights of action. Private persons should be able to seek their own remedies (including, for example, for compensation or specific performance of an obligation).

It is not necessary that the responsibility for all aspects of enforcement of the securities law be given to a single body. There are several models that have been shown to be effective. These include models in which responsibilities are shared between several government or quasi-government agencies or where responsibility is shared with SROs.

The sharing of responsibility and the need for close cooperation may be particularly important in ensuring that only those who have necessary authorization are active participants on the markets; unlicensed persons should be prosecuted.

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[23] *See* IOSCO Resolution No. 35: *Resolution on Enforcement Powers of a Securities and Futures Supervisory Agency* (E.C.), September 1996; IOSCO Resolution No. 37, *Resolution on Enforcement Powers* (T.C.), February 1997; IOSCO Resolution No. 39: *Resolution on Enforcement Powers* (P.C.), November 1997; and IOSCO Resolution No. 40: *Resolution on Principles for Record Keeping, Collection of Information, Enforcement Powers and Mutual Cooperation to Improve the Enforcement of Securities and Futures Laws* (P.C.), November 1997.

[24] Other action may include the imposition of trading restrictions or requirements on individual market participants. For example, position limits, reporting requirements, liquidation only trading or special margin requirements.

8.4. International Enforcement

The international nature of the securities markets and the fact that, frequently, a course of conduct will cross several jurisdictions give rise to a number of particular issues.

Legislation and the enforcement powers of the regulator should be sufficient to ensure that it can be effective in cases of cross-border misconduct.[25] Therefore, the regulator should strive to ensure that it or another authority in its jurisdiction has the necessary authority to obtain information, including statements and documents, that may be relevant to investigating and prosecuting potential violations of laws and regulations relating to securities transactions, and that such information can be shared directly with other regulators or indirectly through authorities in their jurisdictions for use in investigations and prosecutions of securities violations.[26]

The general topic of international cooperation and its importance to effective regulation is addressed in Section 9.

8.5. Money Laundering[27]

The term "money laundering" covers a wide range of activities and processes intended to obscure the source of illegally obtained money and to create the appearance that it has originated from a legitimate source.

Securities regulators should consider the sufficiency of domestic legislation to address the risks of money laundering. The regulator should also require that market intermediaries have in place policies and procedures designed to minimize the risk of the use of an intermediaries business as a vehicle for money laundering.

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25 *See* IOSCO Public Document No. 83, *Securities Activity on the Internet*, IOSCO Technical Committee, September 1998 (in particular, Key Recommendations 14 – 16 and text), IOSCO Public Document No. 120, *Securities Activity on the Internet II*, IOSCO Technical Committee, June 2001 and IOSCO Public Document No. 159, *Report on Securities Activity on the Internet* III, IOSCO Technical Committee, October 2003.

26 IOSCO Resolution No. 39: *Resolution on Enforcement Powers* (P.C.), November 1997.

27 *See generally* IOSCO Public Document No. 26, *Report on Money Laundering*, IOSCO Technical Committee, October 1992, IOSCO Public Document No. 103, *Investigating and Prosecuting Market Manipulation*, IOSCO Technical Committee, May 2000 and IOSCO Public Document No. 205, *Anti-Money Laundering Guidance for Collective Investment Schemes*, IOSCO Technical Committee, October 2005.

9. Cooperation in Regulation

9.1. Principles for Cooperation in Regulation

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.

9.2. The Need for Domestic Cooperation[28]

There may be an important need to share information at a domestic level where regulatory divisions based on institutional form exist or where the securities law overlaps with the general law of a jurisdiction. So, for example, cases of fraud or money laundering that involve dealings in securities may require close cooperation between two or more domestic regulators, including law enforcement, regulatory and judicial authorities.

The need for domestic cooperation may extend beyond matters of enforcement and include information relevant to authorization to act in a particular capacity and the reduction of systemic risk, for example, where there are divisions in responsibility for the securities, banking and other financial sectors.

9.3. The Need for International Cooperation

International cooperation between regulators is necessary for the effective regulation of domestic markets. The inability to provide regulatory assistance can seriously compromise efforts towards effective securities regulation. Domestic laws need to remove impediments to international cooperation.[29]

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[28] *See* IOSCO Resolution No. 9: *Resolution on Cooperation in Matters of Surveillance and Enforcement* (P.C.), September 1987; IOSCO Resolution No. 19: *Resolution on International Equity Offers* (P.C.) September 1989; IOSCO Resolution No. 20: *Resolution on Information Sharing Between SROs* (SRO C. C.) November 1990; IOSCO Resolution No. 23: *Resolution on Principles for Memoranda of Understanding* (P.C.), September 1991; IOSCO Resolution No. 26: *Resolution on Money Laundering* (P.C.), October 1992; IOSCO Resolution No. 28: *Resolution on Transnational Securities and Futures Fraud* (P.C.), October 1993; IOSCO Resolution No. 33: *Resolution Concerning Cross-Border Transactions* (P.C.), July 1995; IOSCO Resolution No. 34: *Recommendation on the Recognition of Bilateral Netting Agreements in the Calculation of Capital Requirements for Securities Firms* (T.C.), March 1996; and IOSCO Resolution No. 40: *Resolution on Principles for Record Keeping, Collection of Information, Enforcement Powers and Mutual Cooperation to Improve the Enforcement of Securities and Futures Laws* (P.C.), November 1997.

[29] *See* IOSCO Public Document No. 76, *Report on the Self-Evaluation Conducted by IOSCO Members Pursuant to the 1994 IOSCO Resolution on "Commitment to Basic IOSCO Principles of High*

The increasing internationalization of financial activities and the globalization of markets mean that information relevant to authorizations or approvals is often beyond the immediate jurisdictional reach of the competent regulator. For example, an application for a license may be received from a person known to be registered in another jurisdiction, or registration may be sought for the same offer documents in several jurisdictions.

Similarly, threats to systemic stability are not confined to domestic factors and may include the behavior of individual financial institutions in another jurisdiction. Regulators must consider whether they have adequate information sharing arrangements with regulators in other jurisdictions to allow them to identify and address these threats.

Further, an increasing number of companies have securities listed in more than one jurisdiction and it is common for a significant part of an issuer's commercial activity to take place in a country other than the one in which its stock is listed. Investors frequently invest in foreign markets and securities either directly or in managed funds. An increasing number of collective investment schemes are marketed across jurisdictional boundaries. It is also common for scheme promoters, managers and custodians to be located in several different jurisdictions and they may not be in the same jurisdiction as investors to whom the scheme is promoted.

Similar financial products may be traded on various markets in several countries; moreover, there are many derivatives in which the underlying product or reference price is traded, produced or derived on foreign markets.

Fraud, market manipulation, insider trading and other illegal conduct that crosses jurisdictional boundaries can and does occur more and more frequently in a global market aided by modern telecommunications.

The importance of international cooperation in investigations and inquiries into possible breach is also apparent from some of the common characteristics of breaches of securities law, such as shifting the proceeds of crime to foreign jurisdictions; wrongdoers fleeing to a foreign country; routing transactions through foreign jurisdictions to disguise the identity of parties or the flow of funds; the use of foreign accounts to hide beneficial ownership of shares; and the facilitation of cross-border breaches through the use of international communications media, including the Internet.

Regulatory Standards and Mutual Cooperation and Assistance", IOSCO, November 1997; IOSCO Public Document No. 83, *Securities Activities on the Internet*, IOSCO Technical Committee, September 1998, in particular at Key Recommendations 21 - 24 and text; and IOSCO Public Document No. 111, *Principles for the Oversight of Screen-Based Trading Systems for Derivatives Products - Review and Additions*, IOSCO Technical Committee, October 2000. *See also* IOSCO Resolution No. 39: *Resolution on Enforcement Powers* (P.C.), November 1997; IOSCO Resolution No. 40: *Resolution on Principles for Record Keeping, Collection of Information, Enforcement Powers and Mutual Cooperation to Improve the Enforcement of Securities and Futures Laws* (P.C.), November 1997; IOSCO Public Document No. 126, *IOSCO Multilateral MOU*, IOSCO May 2002, IOSCO Public Document No. 159, *Report on Securities Activity on the Internet III*, IOSCO Technical Committee, October 2003.

In circumstances such as those described above, effective regulation can be compromised when necessary information is located in another jurisdiction and is not available or accessible.[30]

Cooperative mechanisms should, therefore, be put into place at the international level to facilitate the detection and deterrence of cross-border misconduct and to assist in the discharge of licensing and supervisory responsibilities. Among these are memoranda of understanding.

9.4. The Scope of Cooperation

The form and content of the cooperation will vary from case to case.[31] It is important that assistance can be provided not only for use in investigations but also for other types of inquiry, as part of a compliance program for the purpose of preventing illicit activities. There may also be a need to exchange general information about matters of regulatory concern, including financial and other supervisory information, technical expertise, surveillance and enforcement techniques, and investor education.

Memoranda of understanding or other documented arrangements help to add certainty to the process of information exchange.[32] Nevertheless, the mere formality of an arrangement is no substitute for a close and cooperative arrangement.

These arrangements, whether formal or informal, should have several basic characteristics:

- identification of the circumstances under which assistance may be sought;

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30 *See* IOSCO Resolution No. 9: *Resolution on Cooperation in Matters of Surveillance and Enforcement* (P.C.), September 1987; IOSCO Resolution No. 19: *Resolution on International Equity Offers* (P.C.) September 1989; IOSCO Resolution No. 20: *Resolution on Information Sharing Between SROs* (SRO C. C.), November 1990; IOSCO Resolution No. 23: *Resolution on Principles for Memoranda of Understanding* (P.C.), September 1991; IOSCO Resolution No. 26: *Resolution on Money Laundering* (P.C.), October 1992; IOSCO Resolution No. 28: *Resolution on Transnational Securities and Futures Fraud* (P.C.), October 1993; IOSCO Resolution No. 33: *Resolution Concerning Cross-Border Transactions* (P.C.), July 1995; IOSCO Resolution No. 34: *Recommendation on the Recognition of Bilateral Netting Agreements in the Calculation of Capital Requirements for Securities Firms* (T.C.), March 1996; and IOSCO Resolution No. 40: *Resolution on Principles for Record Keeping, Collection of Information, Enforcement Powers and Mutual Cooperation to Improve the Enforcement of Securities and Futures Laws* (P.C.), November 1997. *See also* IOSCO Resolution No. 31, *Resolution on Commitment to Basic IOSCO Principles of High Regulatory Standards and Mutual Cooperation and Assistance* (*Self-Evaluation*) (P.C.), October 1994; IOSCO Public Document No. 111, *Principles for the Oversight of Screen-Based Trading Systems for Derivatives Products - Review and Additions*, IOSCO Technical Committee, October 2000; and IOSCO Public Document No. 86, *Guidance on Information Sharing*, IOSCO Technical Committee, March 1998.

31 The latter may require, for example, among other things: routine sharing of information on questionable activities and proven frauds; information on any concern about an applicant for licensing, listing or registration; information about the current circumstances of a license holder or issuer; information that may be needed to minimize the adverse effects of market disruptions, including contingency plans, contact persons and structural measures to address market disruption; and information on market conditions such as actions taken by market authorities, prices, trading activities, and market data, IOSCO Public Document No. 248, *Multijurisdictional information sharing and market oversight*, IOSCO Technical Committee, April 2007.

32 As to the content of memoranda of cooperation, *see generally* IOSCO Public Document No. 17, *Principles of Memoranda of Understanding*, IOSCO Technical Committee, September 1991. *See also* IOSCO Public Document No. 86, *Guidance on Information Sharing*, IOSCO Technical Committee, March 1998.

- identification of the types of information and assistance that can be provided;
- safeguards of the confidentiality of information transmitted;
- a description of the permitted uses of the information.

The design of these information sharing mechanisms should take into account the following factors:

- which market authority or regulator has access to and is able to provide the information or assistance;
- how such access can be obtained under applicable law;
- confidentiality and use restrictions under applicable law;
- the form and timing of the assistance or information sharing;
- the applicability of other arrangements, including MOUs, between such authorities for sharing investigative and financial information.

The arrangements may also provide for the limitation of liability and the rights of third parties, routine consultations between authorities, and a public policy exception to the provision of information.

Where assistance to another authority is provided through the provision of confidential information gathered by the regulator in the exercise of its functions or powers, particular care must be taken to ensure that the information is provided subject to conditions which, to the extent consistent with the purpose of the release, preserve the confidentiality of that information.

The removal of any "dual illegality" conditions to information sharing and regulatory cooperation is important. As a transitional matter, while a jurisdiction moves towards the removal of dual illegality conditions, it is important that any conditions be interpreted flexibly and in a manner that minimizes impact upon international cooperation.

Assistance in taking substantive action may also be necessary. When it is within their powers, regulators can more effectively enforce securities laws when they are able to prevent the dissipation or secreting of the fruits of fraud or other misconduct, thus facilitating the return of money to injured investors.[33]

The form of assistance may include:[34]

- assistance in obtaining public or non-public information, for example, about a license holder, listed company, shareholder, beneficial owner or a person exercising control over a license holder or company;
- assistance in obtaining banking, brokerage or other records;
- assistance in obtaining voluntary cooperation from those who may have information about the subject of an inquiry;
- assistance in obtaining information under compulsion - either or both the production of documents and oral testimony or statements;
- assistance in providing information on the regulatory processes in a jurisdiction, or in obtaining court orders, for example, urgent injunctions.

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[33] IOSCO Public Document No. 55, *Measures Available on a Cross-Border Basis to Protect Interests and Assets of Defrauded Investors*, IOSCO Technical Committee, July 1996.

[34] IOSCO Public Document No. 41, *Report on Issues Raised for Securities and Futures Regulators by Under-Regulated and Uncooperative Jurisdictions*, IOSCO Technical Committee, October 1994.

9.5. Cooperation on Financial Conglomerates[35]

The growing emergence of financial conglomerates that combine the activities of firms in different financial sectors and, in some jurisdictions, of financial and non-financial firms has heightened the need for cooperative efforts to improve the effectiveness of supervisory methods and approaches. Without proper cooperation between regulators it may be difficult to be aware of all the activities of a group. Such cooperation is particularly important when, as is commonly the case, the group is active in several jurisdictions.

The particular procedures used for the supervision of financial conglomerates must reflect the domestic law of the places in which they operate and must take account of the possibility that relevant regulatory responsibility may continue to be shared between agencies. It is nevertheless possible to identify some general issues that should be considered as matters requiring close supervisory cooperation:

- Structure of financial conglomerates;
- Capital requirements in conglomerate groups;[36]
- Investments in companies within the same group;
- Intra group exposures and group-wide exposures;[37]
- Relationships with shareholders;
- Management responsibility and the control of regulated entities.

It is also appropriate to consider the regulator's capacity to exchange information with other regulators, for example in the banking and insurance sectors at both the domestic and international levels. Again, such exchanges of information must be consistent with the proper maintenance of confidentiality and the protection of personal data.

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35 IOSCO Public Document No. 88, *Supervision of Financial Conglomerates*, jointly released by IOSCO, the International Association of Insurance Supervisors, and the Basle Committee on Banking Supervision ("Joint Forum on Financial Conglomerates"), February 1999.

36 *See generally* IOSCO Public Document No. 102, *Risk Concentration Principles*, Joint Forum on Financial Conglomerates, December 1999.

37 *See generally* IOSCO Public Document No. 101, *Intra-Group Transactions and Exposures Principles*, Joint Forum on Financial Conglomerates, December 1999.

Part III - Issuers, Market Intermediaries, and Secondary Markets

Part III considers the implementation of the objectives of regulation in the day-to-day regulation of the market with particular reference to issuer disclosure, the conduct of market intermediaries, secondary trading and the clearance and settlement of transactions.

10. Issuers[38]

10.1. Principles for Issuers

14 There should be full, accurate and timely disclosure of financial results and other information which is material to investors' decisions.

15 Holders of securities in a company should be treated in a fair and equitable manner.

16 Accounting and auditing standards should be of a high and internationally acceptable quality.

10.2. The Scope of this Section and the Need to Regulate Issuers

This section is mainly concerned with the public offering and trading of securities. It therefore concerns the content of advertising, and information about issuers, offerings, listing, periodic reports and reports of material events, takeovers or the change in control or change of interest associated with the holding of a publicly traded security.[39]

The term issuer should be understood broadly. It includes all those who raise funds on the market. However, those who offer interests in collective investment schemes are dealt with in the subsequent section.[40] Disclosure requirements of the type described in section 10.4 may extend beyond the issuer to include others, such as directors and senior officers of the company, participating underwriters, and material shareholders.

Regulation of issuers should ensure both investor protection and a fair, orderly and efficient market. Annexure 3 describes some of the other laws necessary to complement securities regulation. Of particular importance in this context are:

- company formation;
- duties of directors and officers;
- regulation of takeover bids and other transactions intended to effect a change in control;
- laws governing the issuance of securities;

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38 The obligation to make relevant disclosure is not limited to issuers. It will be apparent from the text where others have a relevant obligation.

39 Most jurisdictions separately regulate public offerings thereby ensuring general protection of the public while reducing the regulatory burden in the case of non-public undertakings. The definition of what amounts to an offer to the public varies as does the threshold for what constitutes public trading.

40 Derivatives markets are in a separate category. The market operators and intermediaries must ensure, among other things, proper disclosure of the terms of contracts traded, the mechanics of trading and the generic risks related to gearing or leverage.

- disclosure of information to security holders to enable informed voting decisions;
- disclosure of material shareholdings;
- insolvency law.

10.3. Timely Disclosure of Information

Investors should be provided with the information necessary to make informed investment decisions on an ongoing basis. The principle of full, timely and accurate disclosure of current and reliable information material to investment decisions is directly related to the objectives of investor protection and fair, efficient and transparent markets.[41]

10.4. When Disclosure is Required

Disclosure rules should extend to, at least:[42]

- the conditions applicable to an offering of securities for public sale;
- the content and distribution of prospectuses or other offering documents (and, where relevant, short form profile or introductory documents);
- supplementary documents prepared in the offering;
- advertising in connection with the offering of securities;
- information about those who have a significant interest in a listed company;

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[41] IOSCO Public Document No. 132, *Principles for Ongoing Disclosure and Material Development Reporting by Listed Entities*, IOSCO Technical Committee, October 2002. See also IOSCO Public Document No. 145, *Insider Trading – How Jurisdictions Regulate it*, IOSCO Emerging Markets Committee, May 2003.

[42] *See* IOSCO Public Document No. 16, *International Equity Offers - Changes in Regulation Since April 1990*, IOSCO Technical Committee, September 1991; IOSCO Public Document No. 38, *International Equity Offers - Changes in Regulation Since April 1992*, IOSCO Technical Committee, October 1994; IOSCO Public Document No. 61, *International Equity Offers - Changes in Regulation Since April 1994*, IOSCO Technical Committee, September 1996; IOSCO Public Document No 71, *International Equity Offers - Changes in Regulation Since April 1996*, IOSCO Technical Committee, September 1997. *See also* IOSCO Public Document No. 24, *Report on Disclosure Requirements*, IOSCO Development Committee (now called the Emerging Markets Committee), October 1992; IOSCO Public Document No. 32, *Report on Disclosure*, IOSCO Emerging Markets Committee, October 25, 1993; IOSCO Public Document No. 39, *Report on Disclosure and Accounting*, IOSCO Technical Committee, October 1994; and IOSCO Public Document No. 62, *Reporting of Material Events in Emerging Markets*, IOSCO Emerging Markets Committee, September 1996. *See also* IOSCO Public Document No. 81, *International Disclosure Standards for Cross-Border Offerings and Initial Listings by Foreign Issuers*, IOSCO, September 1998; IOSCO Public Document No. 118, *Adapting IOSCO International Disclosure Standards for Shelf Registration Systems*, IOSCO Technical Committee, March 2001; IOSCO Resolution No. 42: *Resolution on IOSCO Endorsement of Disclosure Standards to Facilitate Cross-Border Offerings and Listings by Multinational Issuers* (P.C.), September 1998; IOSCO Resolution No. 44: *Resolution on IASC Standards* (P.C.), May 2000; and IOSCO Public Document No. 141, *General Principles Regarding Disclosure of Management's Discussion and Analysis of Financial Condition and Results of Operations*, IOSCO Technical Committee, February 2003, IOSCO Public Document No. 145, *Insider Trading – How Jurisdictions Regulate it*, IOSCO Emerging Markets Committee, May 2003, IOSCO Public Document No. 182, *Statement on the Development and Use of International Financial Reporting Standards*, IOSCO Technical Committee, February 2005 and IOSCO Public Document No. 242, *International Disclosure Principles for Cross Border Offerings and Listing of Debt Securities by Foreign Issuers*, IOSCO Technical Committee, March 2007.

- information about those who seek control of a company (discussed in greater detail below);
- information material to the price or value of a listed security;
- periodic reports;
- shareholder voting decisions

Disclosure should be clear, reasonably specific and timely.[43] Specific disclosure requirements should be augmented by a general disclosure requirement. Such a general disclosure requirement can provide that disclosure is required of all material information that is relevant to a particular investment decision. Another approach for such a general disclosure requirement provides that disclosure is required of all material information that is necessary to keep disclosures made from being misleading.[44]

Regulation should ensure the sufficiency and accuracy of information[45]. Generally this will involve sanctions or liability on the issuer company and those responsible persons who fail to exercise due diligence in the gathering and provision of information. Regulation should ensure that proper responsibility is taken for the content of information and, depending upon the circumstances, those liable to take responsibility may include the issuing company, underwriters, promoters, directors, authorizing officers of the company, and those experts and advisers who consent to be named in the documentation or provide advice.

Regulators also need to give careful consideration to the circumstances in which it may be necessary to the proper functioning of the market to allow something less than full disclosure: for example, of trade secrets or incomplete negotiations. In the limited circumstances where the market requires some derogation from the objective of full and timely disclosure, there may need to be temporary suspensions from trading or restrictions on the trading activities of those who possess more complete information. In such circumstances, trading should be prohibited in the absence of full disclosure.

10.5. Information About Corporate Control

To safeguard the fair and equitable treatment of shareholders, regulation should require disclosure of the security holdings of management and of those persons who hold a substantial beneficial

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43 *See* IOSCO Public Document No. 1, *International Equity Offers*, IOSCO Technical Committee, September 1989 at pp.7-8, IOSCO Public Document No. 15, *Comparative Analysis of Disclosure Regimes*, IOSCO Technical Committee, September 1991, and IOSCO Public Document No. 81, *International Disclosure Standards for Cross-Border Offerings and Initial Listings by Foreign Issuers*, September 1998 at pp. 5-6. *See also* IOSCO Public Document No. 83, *Securities Activity on the Internet*, IOSCO Technical Committee, September 1998 (in particular, Key Recommendation 5 and text) and IOSCO Public Document No. 120, *Securities Activity on the Internet II*, IOSCO Technical Committee, June 2001, IOSCO Public Document No. 159, *Report on Securities Activity on the Internet III*, IOSCO Technical Committee, October 2003 and IOSCO Public Document No. 242 *International Disclosure Principles for Cross Border Offerings and Listing of Debt Securities by Foreign Issuers*, IOSCO Technical Committee, March 2007 at pp 3-4.

44 Reference should also be made to so-called "merit based" regulation in which the regulator takes some responsibility for assessing the quality of a proposed offering. This approach is generally associated with developing markets and may be of particular benefit where a market lacks a group of analysts and advisers who could analyse information if it were made publicly available. It is therefore, generally regarded as transitional and not necessary in a fully developed market.

45 See IOSCO Public Document No. 229, *Issuer Internal Control Requirements – A Survey*, IOSCO Technical Committee and Emerging Markets Committee, December 2006.

ownership interest in a company. This is generally regarded as information necessary to informed investment decisions in the secondary market.

The level at which disclosure is required varies from jurisdiction to jurisdiction, but is generally set at a level well below that which would be characterized as a controlling interest. More stringent disclosure requirements may be appropriate for persons contemplating exercise of control.

The nature of the disclosure required also varies but full public disclosure is generally thought to best meet the underlying policy rational of disclosure where a change in control of a company has occurred or is contemplated. Regulation should have regard to the information needs of the shareholders of the subject company.

The information necessary to enable informed decision making will vary with the nature of the transaction but the general objective remains true for cash offers, offers by way of tender and exchange, business combinations and privatizations. Generally, in the circumstances described in the preceding sentence, this will require that shareholders of a company:

- have a reasonable time in which to consider any offer under which a person would acquire a substantial interest in the company;
- are supplied with adequate information to enable them to assess the merits of any proposal under which a person would acquire a substantial interest in the company;
- as far as practicable, have reasonable and equal opportunities to participate in any benefits accruing to the shareholders under any proposal under which a person would acquire a substantial interest in the company;
- receive fair and equal treatment (in particular, minority shareholders) in relation to the proposal;
- are not unfairly disadvantaged by the treatment and conduct of the directors of any party to the transaction or by the failure of the directors to act in good faith in responding to or making recommendations with respect to the proposal.

10.6. Accounting and Auditing Standards

Comparability and reliability of financial information are critical to informed decision making. The objective of general purpose financial statements is to provide information about the financial position, results of operations, cash flow and changes in the ownership equity of an enterprise that is useful to a wide range of users for decision making purposes. The statements should be characterized by comprehensibility, consistency, relevance, reliability and comparability. Financial statements should also show the results of the stewardship of management or the accountability of management for the resources entrusted to it. High quality accounting and auditing standards provide a framework for other disclosure obligations.

Accounting and auditing standards are necessary safeguards of the reliability of financial information.

Accounting standards should ensure that fundamental information is available. There should be comprehensive and well-defined accounting principles that are of a high and internationally acceptable quality, and provide accurate and relevant information on financial performance.[46]

[46] See IOSCO Public Document No. 182, *Statement on the Development and Use of International Financial Reporting Standards*, IOSCO Technical Committee, February 2005.

Regulation should be intended to ensure:

- The timeliness and relevance of the information provided to investors and potential investors.
- An appropriate mechanism for the setting of quality standards and to ensure that where there is some dispute or uncertainty, standards can be the subject of authoritative and timely interpretation that is consistently applied.
- An independent verification of financial statements and compliance with accounting principles through professional external auditing.
- Any audit is conducted pursuant to well defined and internationally acceptable standards.
- Rules designed to ensure the independence of the auditor.[47]
- That where a set of international standards acceptable to the regulator is available, their use should be permitted to facilitate efficient cross-border capital raising as an aid to the provision of internationally comparable information and to assist in the more efficient raising of capital.[48]
- A mechanism for enforcing compliance with accounting and auditing standards.[49]

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47 IOSCO Public Document No. 133, *Principles of Auditor Independence and the Role of Corporate Governance in Monitoring an Auditor's Independence*, IOSCO Technical Committee, October 2002. See also IOSCO Statement on International Auditing Standards, November 2007, IOSCO Public Document No. 51, IOSCO Public Document No. 199 *Survey Report on Regulation and Oversight of Auditors*, IOSCO Technical Committee and Emerging Markets Committee, April 2005, IOSCO Public Document No. 229, *Issuer Internal Control Requirements – A Survey*, IOSCO Technical Committee, December 2006, IOSCO Public Document No. 49, *Survey on the Regulation of Non-Audit Services Provided by Auditors to Audited Companies*, IOSCO Technical Committee and Emerging Markets Committee, January 2007 and IOSCO Public Document No. 238, *Board Independence of Listed Companies*, IOSCO Technical Committee, March 2007.

48 *See* IOSCO Resolution No. 12: *Resolution on Harmonization of Accounting and Auditing Standards* (2) (P.C.), November 1988. *See also*, IOSCO Resolution No. 44, *Resolution on IASC Standards* (P.C.), May 2000, IOSCO Public Document No. 182, *Statement on the Development and Use of International Financial Reporting Standards*, IOSCO Technical Committee, February 2005, and IOSCO Public Document No. 184, *Outsourcing of Financial Services*, Joint Forum, February 2005.

49 IOSCO Public Document No. 134, Principles for Auditor Oversight, IOSCO Technical Committee, October 2002.

11. Collective Investment Schemes[50]

11.1. Principles for Collective Investment Schemes

17 The regulatory system should set standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme.

18 The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.

19 Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.

20 Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme.

11.2. Scope of this Section

The term collective investment scheme includes authorized open ended funds that will redeem their units or shares, whether on a continuous basis or periodically. It also includes closed end funds whose shares or units are traded in the securities market. It further includes, unit investment trusts, contractual models and the European UCITS (Undertakings for Collective Investment in Transferable Securities) model.[51]

The legal form taken by collective investment schemes varies between jurisdictions but in all jurisdictions they are becoming increasingly important as a means for investors to achieve a diversified exposure to investment opportunities.

Proper regulation of collective investment schemes is critical to the objective of investor protection and should ensure that investors have access to a fair market. Investors in collective investment schemes rely upon operators of the schemes to manage their funds and to act in their best interests.

11.3. Eligibility to Act as an Operator

There should be clear criteria for eligibility to operate a collective investment scheme. Investor protection is the key objective and to the extent that a regulatory regime imposes specific requirements, factors that may be considered include:

- Honesty and integrity of the operator;

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[50] *See generally* IOSCO Public Document No. 40, *Report on Investment Management - Principles for the Regulation of Collective Investment Schemes and Explanatory Memorandum*, IOSCO Technical Committee, October 1994 and IOSCO Public Document No. 69, *Principles for the Supervision of Operators of Collective Investment Schemes*, IOSCO Technical Committee, September 1997.

[51] In some jurisdictions, closed end funds are not subject to special licensing or supervisory requirements and are, instead, regulated according to the terms of relevant exchange listing rules.

- Competence to carry out the functions and duties of a scheme operator;
- Financial capacity;
- Operator specific powers and duties[52];
- Internal management procedures.[53]

11.4. Supervision of Conduct, Conflicts of Interest and Delegation

The regulatory system should require supervision throughout the life of a particular scheme. Supervision of an operator should promote high standards of competence, integrity and fair dealing. There should be clear powers with respect to:

- Registration and authorization of a scheme;
- Inspections to ensure compliance by scheme operators;
- Investigations of suspected breaches;
- Remedial action in the event of breach or default.

These powers should be sufficient to allow action in respect of all supervised entities with responsibilities under the scheme. [54]

To assist in supervision and to promote compliance, there should also be clear responsibilities for maintaining records of the operations of the scheme.

The operation of a collective investment scheme raises the potential for conflict between the interests of investors in the scheme and those of scheme operators or their associates. Regulation should ensure that the possibility of conflict arising is minimized and that any conflicts which do arise are properly disclosed. Operators should not benefit to the unfair disadvantage of investors in a scheme. Generally this will require regulation covering topics such as best execution, appropriate trading and timely allocation of transactions, commissions and fees, related party transactions and underwriting arrangements.[55]

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[52] See IOSCO Public Document No. 205, *Anti-Money Laundering Guidance for Collective Investment Schemes,* IOSCO Technical Committee, October 2005.

[53] *See generally* IOSCO Public Document No. 136, *Investment Management: Areas of Regulatory Concern and Risk Assessment Methods,* IOSCO Technical Committee, November 2002. For factors relevant to the honesty and integrity of the manager, *see* IOSCO Public Document No. 137, *Investment Management Risk Assessment: Managerial Culture and Effectiveness,* IOSCO Technical Committee, November 2002, and see IOSCO Public Document No. 156, *Investment Management Risk Assessment: Marketing and Selling Practices,* IOSCO Technical Committee, October 2003. See also IOSCO Public Document No. 158, *Collective Investment Schemes as Shareholders: Responsibilities and Disclosure,* IOSCO Technical Committee, October 2003, IOSCO Public Document No. 169, *Performance Presentation Standards for Collective Investment Schemes: Best Practice Standards,* IOSCO Technical Committee, May 2004 and IOSCO Public Document No. 226, *The Regulatory Environment for Hedge Funds, A Survey and Comparison,* IOSCO Technical Committee, November 2006.

[54] See IOSCO Public Document No 179, *An Examination of the Regulatory Issues arising from CIS Mergers, IOSCO Technical Committee*, November 2004.

[55] *See generally* IOSCO Public Document No 108, *Conflicts of Interests of CIS Operators,* IOSCO Technical Committee, May 2000 and IOSCO Public Document No. 207, *Best Practice Standards on Anti Market Timing and Associated Issues for CIS,* IOSCO Technical Committee, October 2005; For a discussion on fees and commissions, see IOSCO Public Document No.157, *Fees and Commissions within the CIS and Asset Management Sector: Summary of Answers to the Questionnaire,* IOSCO Technical Committee, October 2003**,** IOSCO Public Document No. 178 *Final Report on Elements of International Regulatory Standards on Fees and Expenses of Investment Funds,* IOSCO Technical

It is common for aspects of the operation of collective investment schemes to be carried out by delegates. The use of delegates should not, in any way, be permitted to diminish the effectiveness of the primary regulation of a collective investment scheme. A delegate should comply with all regulatory requirements applicable to the conduct of the principal's business activities.[56]

11.5. Legal Form and Structure[57]

The regulatory system should address the legal form and structure of collective investment schemes to enable investors to assess their interests and rights and to enable the pool of investors' funds to be distinguished and segregated from the assets of other entities.

The legal form and structure chosen for collective investment schemes have implications for the nature of the risk of default or breach associated with the scheme. It must be disclosed to investors.

The regulatory system must ensure that these risks to investors are addressed either through statute, conduct rules or mandatory covenants in the constituent documents of a scheme.[58]

11.6. Disclosure to be Made to Investors

There should be a requirement that matters material to the value of the scheme are the subject of disclosure to investors and potential investors.[59] Disclosure about a collective investment scheme should assist investors in understanding the nature of the investment vehicle and the relationship between risk and return, so that investors evaluating scheme performance do not focus solely on return, but also on the risk assumed to produce the return.[60] However, investors should be free to

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Committee, November 2004. In relation to soft commissions, see IOSCO Public Document No. 255, *Soft Commission Arrangements for Collective Investment Schemes*, IOSCO Technical Committee, November 2007.

56 *See generally* IOSCO Public Document No. 113, *Delegation of Functions*, IOSCO Technical Committee, December 2000.

57 *See generally* IOSCO Public Document No. 60, *Guidance on Custody Arrangements for Collective Investment Schemes - A Discussion Paper*, IOSCO Technical Committee, September 1996; IOSCO Public Document No. 107, *Summary of Responses to the Questionnaire on Principles and Best Practice Standards on Infrastructure for Decision Making for CIS Operators*, IOSCO Technical Committee, May 2000.

58 For a discussion of the particular risks involved in hedge funds, *see* IOSCO Public Document No. 142, *Regulatory and Investor Protection Issues Arising from the Participation of Retail Investors in Hedge Funds*, IOSCO Technical Committee, February 2003. For a discussion of the regulatory issues surrounding index funds see IOSCO Public Document No. 163, *Index Funds and the Use of Indices by the Asset Management Industry*, IOSCO Technical Committee, February 2004.

59 *See also* IOSCO Public Document No. 117, *Discussion Paper on the Role of Investor Education in the Effective Regulation of CIS and CIS Operators*, IOSCO Technical Committee, March 2001; and IOSCO Public Document No. 140, *Investor Education*, IOSCO Emerging Markets Committee, January 2003, IOSCO Public Document No 255, *Soft Commission Arrangements for Collective Investment Schemes*, IOSCO Technical Committee, November 2007.

60 *See generally* IOSCO Public Document No. 59, *Disclosure of Risk - A Discussion Paper*, IOSCO Technical Committee, September 1996 and IOSCO Public Document No. 114, *Performance Presentation Standards for Collective Investment Schemes, IOSCO* Emerging Markets Committee, December 2000; IOSCO Public Document No. 130, *Performance Presentation Standards for Collective Investment Schemes (Consultation Draft)*, IOSCO Technical Committee, July 2002; *and*

choose the level of market risk to which they are exposed. There should also be clear disclosure of investment policies.[61]

The goal of disclosure should be to:

- provide investors with sufficient information to evaluate whether and to what extent the scheme is an appropriate investment vehicle for them;
- provide information on a timely basis, in an easy to understand format, having regard to the type of investor.[62]

One particular aspect of disclosure requiring close attention is the disclosure of all fees and other charges that may be levied under the scheme.[63]

Supervision of an operator of a collective investment scheme should ensure that the stated investment policy or trading strategy of the scheme or any policy required under regulation has been followed and that any restrictions on the type or level of investment have been complied with.

11.7. Client Asset Protection[64]

Regulators should recognize the benefits for investor protection and confidence in financial markets of effective mechanisms to protect client assets from the risk of loss and the insolvency of investment firms. Client assets include money, securities and positions, including, in the case of derivatives, accruals thereof or the proceeds thereof, that are held or controlled on behalf of investors in a collective investment scheme.

IOSCO Public Document No. 144, *Performance Presentation Standards for Collective Investment Schemes: Best Practice Standards*, IOSCO Technical Committee, February 2003, IOSCO Public Document No. 207, *Best Practice Standards on Anti Market Timing and Associated Issues for CIS*, IOSCO Technical Committee, October 2005, IOSCO Public Document No. 157, *Fees and Commissions within the CIS and Asset Management Sector: Summary of Answers to Questionnaire*. IOSCO Technical Committee October 2003 and IOSCO Public Document No. 158, *Collective Investment Schemes as Shareholders: Responsibilities and Disclosure*, IOSCO Technical Committee, October 2003. See also IOSCO Public Document No. 178, *Final Report on Elements of International Regulatory Standards on Fees and Expenses of Investment Funds*, IOSCO Technical Committee, November 2004 and IOSCO Public Document No. 169 *Performance Presentation Standards for Collective Investment Schemes: Best Practice Standards*, IOSCO Technical Committee, May 2004.

61 For a discussion of the obligations to disclose voting practices, *see* IOSCO Public Document No. 129, *Collective Investment Schemes as Shareholders: Responsibilities and Disclosure (Consultation Document)*, IOSCO Technical Committee, July 2002, IOSCO Public Document No. 158, *Collective Investment Schemes as Shareholders: Responsibilities and Disclosure*, IOSCO Technical Committee, October 2003, see also IOSCO Public Document No. 179, *An Examination of the Regulatory Issues arising from CIS Mergers*, IOSCO Technical Committee, November 2004. For a discussion on risk, see IOSCO Public Document No. 156, *Investment Management Risk Assessment: Marketing and Selling Practice*, IOSCO Technical Committee, October 2003.

62 See generally IOSCO Public Document No. 131, *Investor Disclosure and Informed Decisions: Use of Simplified Prospectuses by Collective Investment Schemes*' IOSCO Technical Committee, July 2002.

63 *See generally* IOSCO Public Document No. 178, *Final Report on Elements of International Regulatory Standards on Fees and Expenses of Investment Funds*, IOSCO Technical Committee, November 2004.

64 *See generally* IOSCO Public Document No. 57, *Client Asset Protection*, IOSCO Technical Committee, August 1996.

Regulators should enforce within their jurisdictions those mechanisms which best achieve the overall objective of client asset protection, taking into account their insolvency and investment services laws, regulations and practices, and the needs of market efficiency and investor protection.

Regulators should review the adequacy of arrangements within their jurisdiction to ensure that client securities in the course of settlement are not mixed with those belonging to the investment firm.

11.8. Asset Valuation and Pricing

Regulation should seek to ensure that all of the property of a collective investment scheme is fairly and accurately valued and that the net asset value of the scheme is correctly calculated.[65] Information about asset value and pricing should allow the investor to assess performance over time. The interests of the investor are generally better protected by the use of value based reporting wherever reliable market or fair values can be determined.[66]

11.9. Redemption of Interest in a Scheme

The law or rules governing collective investment schemes should enable investors to redeem units upon a basis that is made clear in the constituent documents and should ensure that rights of suspension protect the interest of investors.[67] Regulators should be kept informed of any suspension of redemption rights.[68]

11.10. International Regulatory Cooperation[69]

An increasing number of collective investment schemes are marketed across jurisdictional boundaries. It is also common for scheme promoters, managers and custodians to be located in several different jurisdictions and they may not be in the same jurisdiction as investors to whom the scheme is promoted.[70] The approval of schemes should have regard to the possible need for international cooperation. These matters are addressed more generally in Section 9.3.

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65 IOSCO Public Document No. 69, *Principles for the Supervision of Operators of Collective Investment Schemes*, IOSCO Technical Committee, September 1997; IOSCO Public Document No. 91, *Regulatory Approaches to the Valuation and Pricing of Collective Investment Schemes*, IOSCO Technical Committee, May 1999; IOSCO Public Document No. 92, *CIS Unit Pricing*, IOSCO Emerging Markets Committee, May 1999; and IOSCO Public Document No. 93, *A Comparison Between the Technical Committee Report and the Emerging Markets Committee Report on Valuation and Pricing of Collective Investment Schemes*, Joint Report of the IOSCO Technical and Emerging Markets Committees, May 1999 and IOSCO Public Document No. 253, *Principles for the Valuation of Hedge Fund Portfolios*, IOSCO Technical Committee, November 2007.

66 A mandatory requirement in some jurisdictions. IOSCO Public Document No. 207, *Best Practice Standards on Anti Market Timing and Associated Issues for CIS*, IOSCO Technical Committee, October 2005.

67 *See generally* IOSCO Public Document No. 179, *An Examination of the Regulatory Issues arising from CIS Mergers*, IOSCO Technical Committee, November 2004.

68 *See generally* IOSCO Public Document No. 135, *Suspending Redemptions: A Case Study from September 11 and General Principles*, IOSCO Technical Committee, November 2002.

69 *See generally* IOSCO Public Document No. 54, *Regulatory Cooperation in Emergencies-A Discussion Paper*, IOSCO Technical Committee, June 1996.

70 *See generally* IOSCO Public Document No. 52, *Discussion Paper on International Cooperation in Relation to Cross-Border Activity of Collective Investment Schemes*, IOSCO Technical Committee,

June 1996, IOSCO Public Document No. 226, *The Regulatory Environment for Hedge Funds, A Survey and Comparison*, IOSCO Technical Committee, November 2006.

12. Market Intermediaries

12.1. Principles for Market Intermediaries

21 Regulation should provide for minimum entry standards for market intermediaries.

22 There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.

23 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.

24 There should be a procedure for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.

12.2. Scope of this Section

In this section the expression "market intermediaries" generally includes those who are in the business of managing individual portfolios, executing orders, dealing in or distributing securities and providing information relevant to the trading of securities.

Regulation for the various types of intermediaries should address entry criteria, capital and prudential requirements, ongoing supervision and discipline of entrants, and the consequences of default and financial failure.

The oversight of market intermediaries should primarily be directed to the areas where their capital, client money and public confidence may most be put at risk[71]. These include the risks that:

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[71] *See* IOSCO Resolution No. 13: *Statement on Issues of Clearance and Settlement* (T.C.), June 1989 and IOSCO Resolution No. 27: *Resolution on Market Automation and its Implications for Regulatory Activity* (P.C.), September 1989. *See also* IOSCO Public Document No. 77, *Methodologies for Determining Minimum Capital Standards for Internationally Active Securities Firms Which Permit the Use of Models Under Prescribed Conditions*, IOSCO Technical Committee, May 1998; IOSCO Public Document No. 78, *Risk Management and Control Guidance for Securities Firms and their Supervisors*, IOSCO Technical Committee, May 1998; IOSCO Public Document No. 89, *Recognising a Firm's Internal Market Risk Model for the Purposes of Calculating Required Regulatory Capital: Guidance to Supervisors*, May 1999, and IOSCO Resolution No. 18: *Resolution on Rules of Ethics of Intermediaries* (P.C.), September 1989, and, in particular, the discussion of the various types of risk that market intermediaries may have to address: Market Risk, Credit Risk, Liquidity Risk, Operational Risk, Legal Risk and Systemic Risk. On credit risk, *see* IOSCO Public Document No. 105, *The Management of Credit Risks by Securities Firms and Recommendations to Firms and Regulators*, IOSCO Technical Committee, May 2000. *See also* IOSCO Public Document No. 79, *Framework for Supervisory Information About Derivatives and Trading Activities*, Joint Report by the IOSCO Technical Committee and by the Basle Committee on Banking Supervision, September 1998 and

- incompetence or poor risk management may lead to a failure of due execution, a failure to obtain due settlement or a failure to provide adequate advice;
- breach of duty may lead to misappropriation of client funds or property, the misuse of client instructions for the intermediary's own trading purposes ("front running" or trading ahead of customers), manipulation and other trading irregularities, or fraud on the part of the intermediary or its employees;
- the insolvency of an intermediary may result in loss of client money, securities or trading opportunities, and may reduce confidence in the market in which the intermediary participates.

12.3. Licensing and Supervision

The licensing[72] and supervision of market intermediaries should set minimum standards for market participants and provide consistency of treatment for all similarly situated intermediaries. It should also reduce the risk to investors of loss caused by negligent or illegal behavior or inadequate capital.

The licensing process should require a comprehensive assessment of the applicant and all those who are in a position to control or materially influence the applicant.

The licensing authority should have the power to reject applications that do not meet the standards set.

The licensing authority should also have the power to withdraw or suspend the license or otherwise sanction the licensee whenever the entry criteria are not fulfilled.

Changes of control or material influence should be made known to the competent authority in order to ensure that its assessment on the intermediary remains valid. The regulator should be empowered to withdraw a license or authorization where a change in control results in a failure to meet relevant requirements.

The following matters should be the subject of consideration:

- Regulation should set conditions of entry that make clear the basis of participation. The entry conditions should be consistently applied and need not be determined by the regulator, but where for example it is the responsibility of a self-regulatory organization, the process should be subject to appropriate oversight by the regulator.
- Regulation should determine whether participation in the market by an intermediary should be based upon a demonstration of appropriate knowledge, resources, skills and ethical attitude (including a consideration of past conduct).[73]

IOSCO Public Document No. 122, *Risk Management Practices and Regulatory Capital - Cross-Sectoral Comparison*, Joint Forum on Financial Conglomerates, November 2001.

[72] In some jurisdictions, authorization or registration is used instead of licensing. See IOSCO Public Document No. 178, *Final Report on Elements of International Regulatory Standards on Fees and Expenses of Investment Funds*, IOSCO Technical Committee, November 2004,

[73] Many jurisdictions set out detailed criteria relating to education, training, experience and the so called "fitness and properness" of an applicant to be met before a person may be licensed. These criteria are intended to protect the investor.

- The regulator should have the authority to refuse licensing of an intermediary if these requirements have not been met.
- There should be an initial capital requirement for securities firms as a condition of entry into the market. This ensures that the owners of the business have a direct financial stake in the business. The capital requirement should be maintained and should be the subject of periodic reporting to the regulator or competent SRO. The ongoing capital requirement should be directly related to the nature and amount of business undertaken by an intermediary. The financial position of the intermediary should be regularly audited by independent auditors.

To ensure that continued licensing remains appropriate, there should be a requirement for periodic updating of relevant information and a requirement for reporting material changes in circumstances affecting the conditions of licensing.

To enable investors to better protect their own interests, the regulator should ensure that the public have access to relevant information concerning the licensee, such as the category of license held, the scope of its authorized activities, the identity of senior management and those authorized to act in the name of the intermediary.[74]

12.4. Capital Adequacy[75]

The protection of investors and stability of financial systems are increased by an adequate supervision of ongoing capital standards.

Capital adequacy standards[76] foster confidence in the financial markets and should be designed to allow a firm to absorb some losses, particularly in the event of large adverse market moves, and

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74 The information must be freely available and readily accessible. It may be maintained in a central repository by the regulator or by an SRO.

75 *See* IOSCO Public Document No. 77, *Methodologies for Determining Minimum Capital Standards for Internationally Active Securities Firms Which Permit the Use of Models Under Prescribed Conditions*, IOSCO Technical Committee, May 1998; IOSCO Public Document No. 78, *Risk Management and Control Guidance for Securities Firms and their Supervisors*, IOSCO Technical Committee, May 1998; IOSCO Public Document No. 89, *Recognising a Firm's Internal Market Risk Model for the Purposes of Calculating Required Regulatory Capital: Guidance to Supervisors*, IOSCO Technical Committee, May 1999. On credit risk, *see* IOSCO Public Document No. 105, *The Management of Credit Risk by Securities Firms and Recommendations to Firms and Regulators*, IOSCO Technical Committee, May 2000; IOSCO Public Document No. 79, *Framework for Supervisory Information About Derivatives and Trading Activities*, Joint Report of the IOSCO Technical Committee and the Basel Committee on Banking Supervision, September 1998; IOSCO Public Document No. 97, *Recommendations for Public Disclosure of Trading and Derivatives Activities of Banks and Securities Firms*, Joint Forum on Financial Conglomerates, October 1999; and IOSCO Public Document No. 122, *Risk Management Practices and Regulatory Capital - Cross-Sectoral Comparison*, Joint Forum on Financial Conglomerates, November 2001. *See also* IOSCO Resolution No. 18: *Resolution on Capital Adequacy Standards* (P.C.), September 1989, IOSCO Public Document No. 201, *Application of Basel II to Trading Activities and the Treatment of Double Default Effects*, IOSCO Technical Committee, July 2005.

76 *See* IOSCO Public Document No. 14, *Capital Requirements for Multinational Securities Firms*, IOSCO Technical Committee, November 1990, IOSCO Public Document No. 116, *Multidisciplilnary Working Group on Enhanced Disclosure*, Joint Report of the Basel Committee on Banking Supervision, the Committee on the Global Financial System of the G-10 Central Banks, and IOSCO, April 2001 and IOSCO Public Document No. 122, *Risk Management Practices and Regulatory Capital - Cross-Sectoral Comparison*, Joint Forum on Financial Conglomerates, November 2001.

to achieve an environment in which a securities firm could wind down its business over a relatively short period without loss to its customers or the customers of other firms and without disrupting the orderly functioning of the financial markets. Capital standards should be designed to provide supervisory authorities with time to intervene to accomplish the objective of orderly wind down.

A firm should ensure that it maintains adequate financial resources to meet its business commitments and to withstand the risks to which its business is subject. Risk may result from the activities of unlicensed and off balance sheet affiliates and regulation should consider the need for information about the activities of these affiliates.[77]

A capital adequacy test should address the risks faced by securities firms judged by reference to the nature and amount of the business undertaken by the firm.

12.5. The Conduct of Business Rules and Other Prudential Requirements[78]

Market intermediaries should conduct themselves in a way that protects the interests of their clients and helps to preserve the integrity of the market.[79]

The management of a market intermediary should bear primary responsibility for ensuring the maintenance of appropriate standards of conduct and adherence to proper procedures by the whole firm. This includes the proper management of the risks associated with the business of the intermediary.[80] Regulation should not be expected to remove risk from the market place,[81] but it should ensure that there is proper management of that risk. Periodic evaluation of risk management processes within a regulated entity is appropriate. SROs and third parties, such as external auditors, may be used to assist in this process.

Instances of operational breach can occur despite the existence of internal procedures designed to prevent the relevant misconduct or negligence. It is not practical for the regulator to oversee adherence to those internal procedures on a day to day basis. That is the responsibility of the senior management of the intermediary. Senior management must ensure that they are able to discharge that responsibility. They must themselves understand the nature of the firm's business, its internal control procedures and its policies on the assumption of risk. They must clearly

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77 *See* IOSCO Public Document No. 128, *Sound Practices for the Management of Liquidity Risk at Securities Firms*, IOSCO Technical Committee, June 2002.

78 *See* IOSCO Public Document No. 78, *Risk Management and Control Guidance for Securities Firms and their Supervisors*, IOSCO Technical Committee, May 1998.

79 *See* IOSCO Resolution No. 16: *Resolution on Rules of Ethics of Intermediaries* (P.C.), September 1989. *See also* IOSCO Public Document No. 8, *International Conduct of Business Principles*, IOSCO Technical Committee, July 1990 and IOSCO Public Document No. 83, *Securities Activities on the Internet*, IOSCO Technical Committee, September 1998, (and in particular, Key Recommendations 8 - 11 and text), IOSCO Public Document No. 159, *Report on Securities Activity on the Internet III*, IOSCO Technical Committee, October 2003, IOSCO Public Document No. 167, *Principles on Client Identification and Beneficial Ownership for the Securities Industry*, IOSCO Technical Committee, May 2004 and IOSCO Public Document No. 146, *Initiatives by the BCBS, IAIS and IOSCO to Combat Money Laundering and the Financing of Terrorism*, Joint Forum, June 2003.

80 *See* IOSCO Public Document No. 35, *Operational and Financial Risk Management Control Mechanisms for Over-the-Counter Derivatives Activities of Regulated Securities Firms*, IOSCO Technical Committee, July 1994.

81 In these Objectives and Principles, "operational risk" refers generally to the risk of loss through a failure of systems or deliberate or negligent conduct of staff.

understand the extent of their own authority and responsibilities. They must have access to all relevant information about the business on a timely basis and have available to them all necessary advice on that business and on their own responsibilities. That information must also be available to the regulator upon request.

The details of the appropriate internal organization of a firm will vary according to the size of the firm, the nature of its business and the risks it undertakes but generally regulation of market intermediaries should adhere to the following standards.

- Integrity and Diligence - A firm should observe high standards of integrity and fair dealing and should act with due care and diligence in the best interests of its customers and the integrity of the market. [82]

- Terms of Engagement - A written contract of engagement with a customer will generally be necessary and appropriate. A firm should similarly be ready to provide a customer with a full and fair account of the fulfillment of its responsibilities to the customer.

- Information About Customers - A firm should seek from its customers any information about their circumstances and investment objectives relevant to the services to be provided. Policies and procedures should be established which ensure the integrity, security, availability, reliability and thoroughness of all information, including documentation and electronically stored data, relevant to the firm's business operations. Where the activities of an intermediary extend to the giving of specific advice, it is of particular importance that the advice be given upon a proper understanding of the needs and circumstances of the customer: a matter generally encompassed in the rule of conduct that the intermediary must "know your client."

- Information for Customers - A firm should make adequate disclosure to its customers, in a comprehensible and timely way, of information needed to make a balanced and informed investment decision. It may be necessary for regulation to ensure disclosure in a particular form where products carry a risk that may not be readily apparent to the ordinary investor. Recruitment and training should ensure that staff who provide investment advice understand the characteristics of the products they advise upon.[83]

- Customer Assets - Where a firm has control of or is otherwise responsible for assets belonging to a customer which it is required to safeguard, it should arrange proper protection for them (for example, segregation and identification of those assets) in accordance with the responsibility it has accepted. These measures are intended to: provide protection from defalcation; facilitate the transfer of positions in cases of severe market disruption; prevent the use of client funds for proprietary trading or the financing of an intermediary's operations; and assist in orderly winding up upon the insolvency of an individual firm should that be necessary.

- Market Practice - A firm should observe high standards of market conduct, and it should also comply with any relevant law, code or standard as it applies to the firm. The firm's compliance with all applicable legal and regulatory requirements as well as with the firm's own internal policies and procedures should be monitored by a separate compliance function

[82] See IOSCO Public Document No. 152, *Report on analyst Conflicts of Interest*, IOSCO Technical Committee, September 2003.

[83] Regulators should also play an active role in facilitating training and development programs.

that reports directly to senior management in a structure that makes it independent from operational divisions.

- Operational Controls - Effective policies and operational procedures and controls in relation to the firm's day-to-day business operations should be established. The "effectiveness" of those operational procedures and controls should be evaluated in the light of whether they serve reasonably to ensure:

  (a) an effective exchange of information between the firm and its clients, including required disclosures of information to clients;

  (b) the integrity of the firm's dealing practices, including the treatment of all clients in a fair, honest and professional manner;

  (c) the safeguarding of both the firm's and its clients' assets against unauthorized use or disposition;

  (d) the maintenance of proper accounting and other applicable records, and the reliability of the information; and

  (e) compliance with all relevant legal and regulatory requirements;

  (f) appropriate segregation of key duties and functions, particularly those duties and functions which, when performed by the same individual, may result in undetected errors or may be susceptible to abuses which expose the firm or its clients to inappropriate risks.

- Conflicts of Interests - A firm should try to avoid any conflict of interest arising but, where the potential for conflicts arise, should ensure fair treatment of all its customers by proper disclosure, internal rules of confidentiality or declining to act where conflict cannot be avoided. A firm should not place its interests above those of its customers.

- Proprietary Trading - There should be clear policies within the firm covering the circumstances in which proprietary trading is permitted. The regulator should obtain information about a regulated firm's own proprietary trading and determine that the firm's net capital is adequate in relation to the risk associated with its proprietary trading. The information provided should be sufficient to allow for an understanding of the overall business and risk profile of a firm and its affiliates. It should also allow for the regulation of margin trading and the detection of conflicts of interest or manipulative practices.

12.6. Action in the Event of Financial Failure of an Intermediary[84]

Failure of an intermediary may have systemic consequences.

The regulator should have a clear plan for dealing with the eventuality of failure by market intermediaries. The circumstances of financial failure are unpredictable so the plan needs to be flexible.

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[84] *See* IOSCO Public Document No. 49, *Report on Cooperation Between Market Authorities and Default Procedures*, IOSCO Technical Committee, March 1996.

The regulator should attempt to minimize damage and loss to the investor caused by the failure of an intermediary. A combination of actions to restrain conduct, ensure that assets are properly managed and provide information to the market may be necessary.

Depending upon the prevailing domestic bank regulatory model, it may also be necessary to cooperate with banking regulators, and if the domestic arrangements require it, insolvency regulators. As a minimum position, the regulator should have identified contact persons at other domestic and key foreign regulators.

12.7. Supervision of Intermediaries

Regulation should ensure that there is proper ongoing supervision with respect to market intermediaries.[85]

Regulation should provide for:

- Powers of Inspection - The right to inspect the books, records and business operations of a market intermediary should be available to a regulator to ensure compliance with all relevant requirements, even in the absence of a suspected breach of conduct. There must be complementary requirements for the maintenance of comprehensive records.

- Powers of Investigation and Enforcement - The full range of investigatory powers and enforcement remedies discussed in this document, at Section 8, should be available to the regulator or other competent authority in cases of suspected or actual breach.

- Discipline and Revocation - There must be a fair and expeditious process leading to discipline and, if necessary, suspension or revocation of a license.

- Discipline and license revocation could be delegated to an acceptable SRO but only with regulatory oversight and not on an exclusive basis.

- Complaints - There should be an efficient and effective mechanism for the resolution of investor complaints.

12.8. Investment Advisers

Investment advisers are those principally engaged in the business of advising others regarding the value of securities or the advisability of investing in, purchasing or selling securities.

If an investment adviser also deals on behalf of customers, the capital and other operational controls discussed above as applicable to other market intermediaries also should apply to the adviser. If the adviser does not deal, but is permitted to have custody of client assets, regulations should provide for the protection of client assets, including segregation and periodic inspections (either by the regulator or an independent third party).

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[85] *See* IOSCO Resolution No. 35: *Resolution on Enforcement Powers of a Securities and Futures Supervisory Agency* (E.C.), September 1996; IOSCO Resolution No. 37, *Resolution on Enforcement Powers* (T.C.), February 1997; IOSCO Resolution No. 39: *Resolution on Enforcement Powers* (P.C.), November 1997; and IOSCO Resolution No. 40: *Resolution on Principles for Record Keeping, Collection of Information, Enforcement Powers and Mutual Cooperation to Improve the Enforcement of Securities and Futures Laws* (P.C.), November 1997.

In regulating the activities of investment advisers, the regulator may elect to place emphasis on the substantive licensing criteria, and the capital and other requirements recommended for regulation of other market intermediaries in Sections 12.3 - 12.6. Alternatively, the regulator may opt for a disclosure based regime designed to permit potential advisory clients to make an informed choice of advisers.

At a minimum however, the regulatory scheme selected should contain the following elements:

- a licensing regime that is sufficient to establish authorization to act as an investment adviser and to ensure access to an up to date list of authorized advisers;
- bars against the licensing of persons who have violated securities or similar financial laws, or criminal statutes during a specified time period preceding their application;
- record keeping requirements;
- clear and detailed requirements setting out the disclosures to be made by the adviser to potential clients, including: descriptions of the adviser's educational qualifications, relevant industry experience, disciplinary history (if any),[86] investment strategies, fee structure and other client charges, potential conflicts of interest, and past investment performance (if relevant). Disclosure should be required to be updated periodically and as material changes occur;
- rules and procedures designed to prevent guarantees of future investment performance, misuse of client assets, and potential conflicts of interest;
- inspection and enforcement powers.

There are investment advisers who neither deal on behalf of clients nor hold client assets nor have custody of client assets nor manage portfolios, but who only offer advisory services without at the same time offering other investment services. In this case it may be sufficient if the market intermediaries on whose services these investment advisers advise are adequately licensed according to the principles stated above; therefore, separate licensing of the investment adviser may not be strictly required.

[86] These matters are of particular importance where there are no entry criteria based on education, training or experience.

13. The Secondary Market

13.1. Principles for the Secondary Market

25 The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight.

26 There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.

27 Regulation should promote transparency of trading.

28 Regulation should be designed to detect and deter manipulation and other unfair trading practices.

29 Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.

30 Systems for clearing and settlement of securities transactions should be subject to regulatory oversight, and designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.

13.2. Scope of this Section

In this document, the word "markets" should be understood in its widest sense, including facilities and services relevant to equity and debt securities, options and derivative products.

In addition to traditional organized exchanges, secondary markets should be understood to include various forms of off-exchange market systems. These systems include electronic "bulletin boards" and "proprietary" systems developed by intermediaries, typically offering their services to other brokers, banks and institutional investors who meet the operator's credit standards.

The organized exchanges are the main focus of regulation. Regulation appropriate to a particular secondary market will depend upon the nature of the market and its participants.[87]

Regulation will increasingly need to take account of the growing internationalization of trading and the impact of technological developments on markets and their infrastructure.

[87] See IOSCO Public Document No. 200, *Exchange Demutualization in Emerging Markets,* IOSCO Emerging Markets Committee, April 2005 and IOSCO Public Document No. 225, *Regulatory Issues Arising from Exchange Evolution,* IOSCO Technical Committee, November 2006.

13.3. Securities Exchanges and Trading Systems

The level of regulation will depend upon the proposed market characteristics, including the structure of the market, the sophistication of market users and rights of access and the types of products traded. In some cases it will be appropriate that a trading system should be largely exempt from direct regulation but will require approval from the relevant regulator after proper consideration by the regulator of the type of approval (or exemption) necessary.[88]

The establishment of new exchanges or trading systems, requires proper approval. When direct regulation is appropriate, relevant matters include:[89]

- Operator Competence - Regulation should assess the competence of the operator of a trading facility as a secondary market. The competence of the operator is an ongoing requirement.

- Operator Oversight - The operator should be accountable to the regulator and, when assuming principal, settlement, guarantee or performance risk, must comply with prudential and other requirements designed to reduce the risk of non-completion of transactions.

- Admission of Products to Trading - The regulator should, as a minimum requirement, be informed of the types of securities and products to be traded on the trading system. The regulator should approve the rules governing the trading of the product. The proper design of the terms and conditions attaching to a product reduces the susceptibility of the product to market abuses, including manipulation. Consideration of product design principles and trading conditions is a critical aspect of ensuring a fair, orderly, efficient, transparent and liquid market.[90]

- Admission of Participants to the Trading System - The regulator should ensure that access to the system or exchange is fair and objective. The regulator should oversee the related admission criteria and procedures.

- Provision of Trading Information - The regulator should verify that all similarly situated market participants have equitable access to trading information. Any categorization of participants, for the purpose of access to pre-trade information, should be made on a

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88 *See generally* IOSCO Public Document No. 90, *Supervisory Framework for Markets* IOSCO Technical Committee, May 1999.

89 *See* IOSCO Public Document No. 42, *Report on Issues in the Regulation of Cross-Border Proprietary Screen-Based Trading Systems*, IOSCO Technical Committee, October 1994; IOSCO Public Document No. 6, *Screen-Based Trading Systems for Derivative Products*, June 1990; and IOSCO Public Document No. 111, *Principles for the Oversight of Screen-Based Trading Systems for Derivatives Products - Reviews and Additions*, October 2000. *See also* IOSCO Public Document No. 83, *Securities Activity on the Internet*, IOSCO Technical Committee, September 1998 and IOSCO Public Document No. 120, *Securities Activity on the Internet II*, IOSCO Technical Committee, June 2001 and IOSCO Public Document No. 159, *Report on Securities Activity on the Internet III*, IOSCO Technical Committee, October 2003.

90 *See also* IOSCO Public Document No. 85, *The Application of the Tokyo Communiqué to Exchange-Traded Financial Derivatives Contracts*, IOSCO Technical Committee, September 1998. *See also* IOSCO Public Document No. 22, *Coordination Between Cash and Derivative Markets - Contract Design of Derivative Products on Stock Indices and Measures to Minimize Market Disruption*, IOSCO Technical Committee, October 1992. *See also* IOSCO Public Document No. 143, *Indexation: Securities Indices and Index Derivatives*, IOSCO Technical Committee, February 2003, regarding non-diversified indices.

reasonable basis. Any differential access to such information should not unfairly disadvantage specific categories of participants.

- Routing of Orders - The system's order routing procedures must be clearly disclosed to the regulator and to market participants. They must be applied fairly and should not be inconsistent with relevant securities regulation (e.g. client precedence or prohibition of front running or trading ahead of customers).

- Trade Execution - The order execution rules must be disclosed to the regulator and to market participants. They must be fairly applied to all participants.

- Post Trade Reporting and Publication - Information on completed transactions should be provided on the same basis to all participants. Full documentation and an audit trail must be available.

- Supervision of System and Participants by the Operator - The regulator should assess the reliability of all the arrangements made by the operator for the monitoring, surveillance and supervision of the trading system and its participants to ensure fairness, efficiency, transparency and investor protection, as well as compliance with securities legislation. The trading system operator should provide the regulator with its dispute resolution and appeal procedures, its technical systems standards and procedures related to operational failure, information on its record keeping system, reports of suspected breaches of law, procedures for holding client funds and securities, and information on how trades are cleared and settled. There must be mechanisms in place to identify and address disorderly trading conditions and to ensure that contravening conduct, when detected, will be dealt with.

- Trading Disruptions - Details of procedures for trading halts,[91] other trading limitations and assistance available to the regulator in circumstances of potential trading disruption on the system should be provided to the regulator.

The rules and operating procedures governing these matters should be available to market participants.

13.4. Ongoing Supervision of Systems and Information About Market Processes

The regulator must remain satisfied that the relevant conditions thought necessary as pre-requisites to approval remain in place during operation.[92]

Amendments to the rules of the trading system should be provided to or approved by the regulator.

Approval of the trading system should be re-examined or withdrawn by the regulator when it is determined that the system is unable to comply with the conditions of its approval or with securities law or regulation.

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91 *See* IOSCO Public Document No. 138, Report on *Trading Halts and Market Closures*, IOSCO Technical Committee, October 2002.

92 *See generally* IOSCO Public Document No. 90, *Supervisory Framework for Markets*, IOSCO Technical Committee, May 1999.

13.5. Transparency of Trading[93]

Transparency may be defined as the degree to which information about trading (both for pre-trade and post-trade information) is made publicly available on a real-time basis. Pre-trade information concerns the posting of firm bids and offers, in both quote and order-driven markets, as a means to enable investors to know, with some degree of certainty, whether and at what prices they can deal. Post-trade information is related to the prices and the volume of all individual transactions actually concluded.

Ensuring timely access to information is a key to the regulation of secondary trading. Timely access to relevant information about secondary trading allows investors to better look after their own interests and reduces the risk of manipulative or other unfair trading practices.[94]

Where a market permits some derogation from the objective of real time transparency, the conditions need to be clearly defined. The market authority (being either or both of the exchange operator and the regulator) should, in any such event, have access to the complete information to be able to assess the need for derogation and, if necessary, to prescribe alternatives.

13.6. Prohibition of Manipulation and Other Unfair Trading Practices[95]

The regulation of trading in the secondary market should prohibit market manipulation, misleading conduct, insider trading and other fraudulent or deceptive conduct which may distort the price discovery system, distort prices and unfairly disadvantage investors.[96]

Such conduct may be addressed by direct surveillance, inspection, reporting, product design requirements, position limits, settlement price rules or market halts complemented by vigorous enforcement of the law and trading rules.[97]

The regulator must ensure that there are in place arrangements for the continuous monitoring of trading. These arrangements should trigger inquiry whenever unusual and potentially improper trading occurs.

Particular care must be taken to ensure that regulation is sufficient to cover cross-market conduct, for example, conduct in which the price of an equity product is manipulated in order to benefit through the trading of options, warrants or other derivative products.

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93 *See* IOSCO Public Document No. 27, *Transparency on Secondary Markets - A Synthesis of the IOSCO Debate*, IOSCO Technical Committee, December 1992 and IOSCO Public Document No. 124, *Transparency and Market Fragmentation*, November 2001, IOSCO Public Document No. 168, *Transparency of Corporate Bond Markets*, IOSCO Technical Committee, May 2004, IOSCO Public Document No. 161, *Stock Repurchase Programs*, IOSCO Technical Committee, February 2004 and IOSCO Public Document No. 147, *Report on Transparency of Short Selling*, IOSCO Technical Committee, June 2003.

94 *See generally* the discussion in Public Document No. 27 at Sections 3 and 4 on the content of information.

95 See generally IOSCO Public Document No. 208, *Policies on Error Trades*, IOSCO Technical Committee, October 2005.

96 *See* IOSCO Public Document No. 103, *Investigating and Prosecuting Market Manipulation*, IOSCO Technical Committee, May 2000; and IOSCO Public Document No. 145, *Insider Trading - How Jurisdictions Regulate It*, IOSCO Emerging Markets Committee, May 2003.

97 *See also* IOSCO Public Document No. 85, *The Application of the Tokyo Communiqué to Exchange-Traded Financial Derivatives Contracts*, IOSCO Technical Committee, September 1998.

When the underlying interest is traded in a jurisdiction other than the one where a derivative instrument is traded, or where identical financial products are traded in two jurisdictions, there may be increased potential for fraud or manipulation because of the difficulty of a regulator in one jurisdiction to monitor market activity directly or to conduct complete investigations of market activities in another jurisdiction. There must be adequate information sharing between relevant regulatory authorities, sufficient to ensure effective enforcement.[98]

13.7. Large Exposures, Default Procedures and Market Disruptions[99]

The expression "large exposure" refers to an open position that is sufficiently large to pose a risk to the market or to a clearing firm. Market authorities should closely monitor large exposures and share information with one another so as to permit appropriate assessment of risk.

Market authorities should promote mechanisms that facilitate the sharing of the above information through appropriate channels.

Trigger levels are qualitative or quantitative criteria that are used to identify a large exposure. Market authorities should establish trigger levels appropriate to their markets, and continuously monitor the size of positions on their markets. To perform this monitoring function market authorities should have access to information on the size and beneficial ownership of positions held by direct customers of market members. Market authorities can then take the appropriate action, such as requiring the member to reduce the exposure, or increasing margin requirements.

Where a market member does not make the relevant information available to the market authority, the authority should be able to take appropriate action such as imposing limitations on future trading by the member, requiring liquidation of positions, increasing margin requirements, and revoking trading privileges.

Market authorities should make relevant information concerning market default procedures available to market participants.

Regulators should ensure that the procedures relating to defaults are effective and transparent.

Market authorities for related products (cash or derivative) should consult with each other as soon as practicable with a view to minimizing the adverse effects of market disruption. The information that may be needed includes contingency plans, contact persons and structural measures to address market disruption, and information about market conditions (such as actions taken by market authorities, prices, trading activities, and aggregate market data). These matters are further discussed at Section 12.

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98 Id. *See also* IOSCO Public Document No. 143, *Indexation: Securities Indices and Index Derivatives*, IOSCO Technical Committee, February 2003, pp. 35-40.

99 *See generally* IOSCO Public Document No. 138, Report on *Trading Halts and Market Closures*, IOSCO Technical Committee, October 2002; IOSCO Public Document No. 49, *Report on Cooperation Between Market Authorities and Default Procedures*, IOSCO Technical Committee, March 1996; IOSCO Public Document No. 22, *Coordination Between Cash and Derivative Markets - Contract Design of Derivative Products on Stock Indices and Measures to Minimize Market Disruption*, October 1992; and IOSCO Public Document No. 29, *Mechanisms to Enhance Open and Timely Communication Between Market Authorities of Related Cash and Derivative Markets During Periods of Market Disruption*, IOSCO Technical Committee, October 1993.

13.8. Clearing and Settlement[100]

Clearing and settlement systems are systems providing the process of presenting and exchanging data or documents in order to calculate the obligations of the participants in the system, to allow for the settlement of these obligations, and the process of transferring funds and / or securities. The rules and operating procedures governing the clearing and settlement systems should be available to market participants.

There should be direct supervision of clearing and settlement systems and their operators.

13.9. Regulation and Standards for Clearing and Settlement Systems[101]

Regulators of clearing and settlement organizations should require a framework that permits them to ensure the accountability of such systems, to monitor and, if possible, predict and prevent problems associated with clearing and settlement. This includes the authority of the regulator to promote efficiency and safety through review of system mechanisms and establishment of operating standards. Regulators should be empowered to issue directions which the clearing and settlement organizations must satisfy.

The operation of clearing and settlement services should be subject to inspection and periodic review by the regulator. The clearing and settlement organizations should be required to make reports to the regulator and may be required to submit to periodic and, if necessary, special audits and examinations.

13.10. Verification of Trades in Clearing and Settlement Systems

The arrangements for clearing and settlement systems should provide for the expeditious verification of a trade. The standard should be as close to real time verification as possible. Information should be available which records the transaction, allows it to be checked and provides the basis for settlement. Fully automated links between the trading system and the settlement system will generally assist in such verification. Where exchanges or trading systems do not provide such links they should require participants to have arrangements that ensure the rapid and accurate transmission of transaction data to the clearing service.

13.11. Risk Issues in Clearing and Settlement Systems: Margining, Netting, and Short Selling and Securities Lending

There should be procedures to identify and monitor risks on an on-going basis. Regulators of the securities market should be interested not only in risk reduction but also in the assumption and shifting of risk amongst participants.

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[100] *See* IOSCO Resolution No. 13: *Statement on Issues of Clearance and Settlement* (T.C.), June 1989 and IOSCO Resolution No. 27: *Resolution on Market Automation and its Implications for Regulatory Activity* (P.C.), September 1989. *See also* IOSCO Public Document No. 74, *Towards a Legal Framework for Clearing and Settlement in Emerging Markets,* IOSCO Emerging Markets Committee, November 1997.

[101] *See generally* IOSCO Public Document No. 123, *Recommendations for Securities Settlement Systems,* Joint Report of the IOSCO Technical Committee and the Committee on Payment and Settlement Systems of the Bank for International Settlements, November 2001.

It is crucial that the stability, financial health and activities of participants in clearing and settlement systems be monitored in order to minimize the risk of failure of individual participants and overall risk to the systems. There must be information available on the capacity of clearing members to meet calls in a timely way and clarity of procedures in the event of default. Margin requirements (discussed below) may be used in combination with other mechanisms to manage risk to market participants, clearing houses and exchanges. Other risk controls may include: circuit breakers, position limits, price limits, trading halts, capital adequacy, risk management systems, operational standards, lending limitations, insurance coverage, back-up systems and guarantee funds.[102]

A short settlement period will reduce risk to participants. T+3 is the standard settlement time frame recommended by the Group of Thirty for equities markets. There should be delivery versus payment systems in which transfer of ownership occurs at the same time as payment. Delivery versus payment systems reduce the risk that a participant will deliver full value to a counterparty and receive nothing in return. Such systems provide that ownership should not transfer unless payment also occurs.

A centralized securities depository or registry, linked with clearing and settlement system facilities provides a strong foundation for secure and efficient securities clearing and settlement systems. Over time, jurisdictions should move to de-materialize securities or to immobilize securities in regulated depositories or registries.

Derivatives settlement systems should be symmetric to avoid liquidity risk. Pays and collects should be handled contemporaneously.

13.11.1. Margining[103]

Margin calls can play an important role, along with other safeguards, in protecting the financial safety and integrity of markets. Margin requirements should be designed so that sufficient funding is available to cover likely trading exposures. The adequacy of margin requirements should periodically be reviewed.

Margin levels and procedures should be designed to reduce the exposure of market participants, including the clearing house, to credit, market and other risks - in particular, the risk of default by a market participant as a result of price movements in individual instruments and changes in market volatility.

The costs of margin must be considered in light of the benefit of reducing risk. For example, a consequence of high margin levels could be to reduce the leverage effect associated with certain financial instruments and increase the cost of trading which may affect the economic usefulness of ~~a~~ certain products.

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[102] The regulator should require sufficient stress testing of risk management and back-up systems.

[103] *See* IOSCO Public Document No. 50, *Report on Margin*, IOSCO Technical Committee, March 1996 and IOSCO Public Document No. 22, *Coordination Between Cash and Derivative Markets - Contract Design of Derivative Products on Stock Indices and Measures to Minimize Market Disruption*, October 1992 for a discussion of: setting margin levels; calculation; collection and monitoring; default; extraordinary conditions; effective communication; and cross margining.

Consideration should be given to cross-margining and the use of a wide range of reasonably liquid collateral. To cover the volatility of derivatives trading, marking to market and intra-day settlements and margining are widely used and should be encouraged.

13.11.2. Netting

In this context, netting refers to the reduction in the amount of processing or the levels of exposure in a settlement system achieved by setting a participant's debits and credits off against each other leaving a smaller net obligation. Netting with novation and real time gross settlement are efficient settlement mechanisms. The regulator and market participants should study market volumes and participation to determine which mechanism is appropriate for their market place.[104]

13.11.3. Short Selling and Securities Lending

Short selling is regarded as a useful mechanism in some jurisdictions as an aid to liquidity[105]. Where short selling is permitted, regulation must guard against manipulative practices, including those associated with a significant short position. In some jurisdictions this involves a combination of permitting securities lending and restricting short sales to liquid stocks. Disclosure of short sales and securities lending positions (or, at least, their reporting to the regulator) is a tool for the further reduction of risk.

[104] Novation must be effective on insolvency if it is to contribute to risk management.

[105] Short selling is a necessary component of exchange traded futures and options markets. *See generally* IOSCO Public Document No. 96, *Securities Lending Transactions: Market Development and Implications*, Joint Report by the IOSCO Technical Committee and the Committee on Payment and Settlement Systems of the Bank for International Settlements, July 1999.

Annexure 1

The Legal Framework

Effective securities regulation depends upon an appropriate legal framework. The matters to be addressed in the domestic laws of a jurisdiction include:

(1) Company Law

1.1 company formation
1.2 duties of directors and officers
1.3 regulation of takeover bids and other transactions intended to effect a change in control
1.4 laws governing the issue and offer for sale of securities
1.5 disclosure of information to security holders to enable informed voting decisions
1.6 disclosure of material shareholdings

(2) Commercial Code / Contract Law

2.1 private right of contract
2.2 facilitation of securities lending and hypothecation
2.3 property rights, including rights attaching to securities, and the rules governing the transfer of those rights

(3) Taxation Laws

3.1 clarity and consistency, including, but not limited to, the treatment of investments and investment products

(4) Bankruptcy and Insolvency Laws

4.1 rights of security holders on winding up
4.2 rights of clients on insolvency of intermediary
4.3 netting

(5) Competition Law

5.1 prevention of anti-competitive practices
5.2 prevention of unfair barriers to entry
5.3 prevention of abuse of a market dominant position

(6) Banking Law

(7) Dispute resolution system

7.1 a fair and efficient judicial system (including the alternative of arbitration or other alternative dispute resolution mechanisms)
7.2 enforceability of court orders and arbitration awards, including foreign orders and awards