

**THE TECHNICAL COMMITTEE OF THE INTERNATIONAL ORGANIZATION
OF SECURITIES COMMISSIONS**

**INTERNATIONAL CONDUCT OF
BUSINESS PRINCIPLES**

TABLE OF CONTENTS

Pages

Introduction	2
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PART ONE

ELABORATION OF INTERNATIONAL CONDUCT OF BUSINESS PRINCIPLES	3 - 6
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I - The evolution of financial markets and the development of conduct of business standards	3 - 4
II - Reasons for formulating conduct of business principles on an international level	4
III - The objectives of the international conduct of business principles	4 - 5
IV - The implementation of conduct of business principles	5 - 6
V - Conclusion	6

PART TWO

INTERNATIONAL CONDUCT OF BUSINESS PRINCIPLES	7 - 9
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I - Definition of conduct of business principles	7
II - Impact of the principles proposed by the working party	7
III - Persons to whom the principles apply	7
IV - International conduct of business principles	8 - 9

INTRODUCTION

1 - In January 1990, the Technical Committee of IOSCO decided on the creation of a working group on Principles of ethical conduct. By ethical conduct, the Committee had in mind rules applying to financial intermediaries designed to promote the primacy of the interests of the client and the integrity of the market. The working group was asked to elaborate a set of principles to apply on an international level and to be implemented in each IOSCO member country in accordance with its own legislation, organisation and culture. The Principles were to apply to financial intermediaries, and deal with :

- the need to have available sufficient capabilities for the proper performance of their activities ;
- the need for customer information ;
- the need to treat clients with fairness and diligence ;
- the need to prevent and, should they arise, to treat in a fair manner any conflicts of interest ;
- the need to comply with market regulation and to cooperate with the market authorities ;
- the need to establish staff dealing rules and procedures and to enforce them.

2 - The conclusions of the working group were to be available for the 15th Annual Conference of IOSCO taking place in Santiago in November 1990. The Technical Committee mandated Pierre FLEURIOT of the Commission des Opérations de Bourse to act as the Chairman of the working group. The members of the working group were Hong-Kong, Italy, Japan, Quebec, Sweden, Switzerland, United Kingdom, The Federal Republic of Germany and the SEC and CFTC for the United States, with Australia as a correspondent member.

3 - This report discusses in the first part the elaboration of the international conduct of business principles. The second part of the report contains the principles which have been agreed to by the working group.

PART ONE

ELABORATION OF INTERNATIONAL CONDUCT OF BUSINESS PRINCIPLES

This part describes the reasons for establishing the working party, summarises the views of the working party on the content and objectives of international conduct of business principles and considers briefly methods for elaborating conduct of business rules in various countries.

I - THE EVOLUTION OF INTERNATIONAL FINANCIAL MARKETS AND THE DEVELOPMENT OF CONDUCT OF BUSINESS STANDARDS

4 - The increased focus on conduct of business standards stems from the profound transformation which the world's financial markets have gone through, to varying degrees, since the end of the 1970s. This transformation can be attributed in part to the major phenomenon of internationalization. Issuers, intermediaries, investors and regulatory authorities have all had to respond to this important development. Issuers have resorted increasingly to the international markets to raise capital and to diversify the markets where their financial products are traded. Many intermediaries have established subsidiaries or branches on most of the main financial markets worldwide. Investors have sought to internationalise their portfolios to spread their risks across different financial markets.

5 - Regulatory authorities are confronted with internationalization on three fronts, challenging their traditional methods of operation :

- the internationalization of the intermediaries whose activities they regulate ;
- the increasing volume of cross-border investment ;
- the development of transnational markets which are more difficult to supervise.

6 - The pace of internationalization has been accelerated by rapid advances in technology facilitating cross border transactions of financial services business. Technological changes have changed the mechanism for dissemination of information, and the techniques used in effecting transactions and portfolio management. New methods of trading and information dissemination have, by making possible 24 hour trading, contributed to the globalisation of financial markets. Moreover, developments in trading technology and techniques have created unprecedented challenges to market transparency.

7 - The transformation of the world's financial markets can also be attributed in part to increasing institutionalization of markets, with a growing share of the various financial markets being taken by institutions managing increasingly large financial portfolios, in particular, insurance groups, pension funds, unit trust and portfolio managers. The increasing market share of institutional investors has been accompanied by a reduction in direct investment by small shareholders. Although institutional investors may be able to obtain appropriate services and to protect their own interests (although this is not always the case) smaller investors generally may be at a disadvantage in dealing with financial services firms with superior market information and more sophisticated trading techniques. Smaller investors, whether they participate directly in the markets, or indirectly through mutual funds or pension funds, continue to be considered vital to the functioning of the markets. Their continued participation depends upon confidence in the integrity of the market and in the firms with which they deal.

8 - Accordingly, developments in increasing internationalization and institutionalization require attention to be given to the conduct of business of financial services firms. The formulation of conduct of business principles and the implementation of rules based on such principles can boost investor confidence in the market. In order to reflect the realities of today's markets, such rules of business conduct should be flexible enough to differentiate between professional and non professional market participants.

9 - In addition, a further reason for considering the development of conduct of business principles has been the structural changes which have occurred in many countries. In particular, there has been a move away from single capacity and fixed commissions. Stockbroking is now carried out by multi-functional institutions, which may undertake market making, portfolio management and in many countries banking activities. This situation risks conflicts of interest among the various activities. Finding a solution to the challenges of these changes is a further reason for the introduction of conduct of business principles.

10 - All of these developments have, in one form or another, affected all financial markets. Some countries are responding to them by the elaboration of conduct of business rules.

II - REASONS FOR FORMULATING CONDUCT OF BUSINESS PRINCIPLES ON AN INTERNATIONAL LEVEL

11 - Clearly, one way of dealing with the challenges in different jurisdictions would be to establish separate sets of conduct of business rules or principles in each of those jurisdictions. However, the working group sees considerable advantage in the development of principles for the conduct of business at an international level, both for market participants and domestic regulators.

12 - As far as market participants are concerned, a set of common principles provides basic standards for business conduct, wherever the business is undertaken. This should facilitate cross border business, encouraging competition among firms, with increased consumer choice and lower costs. Commonly agreed principles should also enhance investor understanding, and hence confidence, and so increase investor participation in international markets.

13 - For domestic regulators, including self regulatory organizations, international formulation of conduct of business principles can help in two ways. Firstly, as conduct of business rules increasingly come to reflect principles adopted on an international plane, regulators will be able to draw more on solutions adopted in other countries when developing their own regulatory systems. Secondly, international principles can reinforce the measures adopted by national authorities.

14. On the international front, the formulation of principles of conduct on an international basis should contribute to the effort of international organisations of regulators like IOSCO to resolve problems arising in the world's markets.

III - THE OBJECTIVES OF THE INTERNATIONAL CONDUCT OF BUSINESS PRINCIPLES

A) The scope of the working party's mandate

15 - Firstly, in accordance with its mandate, the working party stresses that it has seen its objective as to elaborate principles, rather than detailed rules of conduct. The working party also saw an important part of its objective as being to establish principles not only for international business but also for domestic business.

16 - The working party adopted the term "conduct of business" rather than "ethical conduct", as originally proposed by the Technical Committee. The change of terminology reflects the working party's conclusion that its objective is to prepare principles which set high standards of behaviour in financial markets. The working party considered that the concept of ethics involved moral standards which might go beyond this pragmatic objective.

17 - Similarly, the working party adopted the expressions "protecting the interests of customers" and "best interests of customers" rather than the expression "promoting the primacy of the interest of the client" which was contained in the mandate of the Technical Committee. It was felt that the latter expression tended to have a more direct reference to "ethical" standards of behavior. The "best interests of customers" phrase employed in the principles was considered to be better related to high standards of business practice.

B) The contents of the principles

18 - Conduct of business principles can be defined as those principles of conduct which should govern the activities of financial services firms in protecting the interests of their customers and the integrity of the market.

19 - The proposed principles focus upon financial intermediaries (brokers, banks, portfolio managers, financial analysts, investment advisers...) and other market participants. The purpose of conduct of business rules is to protect customer interests and enhance market integrity. The second objective widens the scope of the first. It is necessary to protect the interests of all market participants and not just the financial intermediary's own customers.

20 - It is also necessary to distinguish conduct of business provisions from those which address market conduct and practice on such matters as insider trading, market manipulation or fraud. These offences are usually defined in legislation and may be interpreted further through case law. They cover all participants in the markets, both private investors and professionals and may be backed by criminal sanctions. Conduct of business rules however are frequently determined by the professionals themselves, may be applied only to them and may lead only to professional or civil - not criminal - sanctions.

21 - Moreover it is important to distinguish conduct of business rules from capital requirements and liquidity and debt ratios, which are devised to promote market security. In fact, all these rules complement each other in order to assist the smooth operation of the market.

IV - THE IMPLEMENTATION OF CONDUCT OF BUSINESS PRINCIPLES

22 - The working party is firmly of the view that competence for implementing the international conduct of business principles lies with each domestic authority. In this way, implementation will be adapted to local circumstances.

23 - In regulating the conduct of business, domestic authorities all face the same tasks : elaboration of rules, monitoring and enforcement, but the solutions need to be adapted to the local circumstances. The working party considered that it would be useful to discover some information about the variety of methods adopted and issued a questionnaire to its members for that purpose. The following comments are based on the responses received.

The elaboration of conduct of business rules

Sources

24 - Members of the working group referred to two possible sources for conduct of business rules : professional, when the content of the rules stems from a consensus among the professions concerned ; and state, in so far as the content of the rules meets the requirements of the public authorities. It is unlikely that any one system has recourse to only one of these sources and that in each system there is likely to be a mixture of the two in varying proportions. The objectives of rules of business conduct - the smooth running of an activity that is relatively well defined - may nonetheless imply that the professional source will in most cases play a very important role.

The implementation of conduct of business rules

25 - Conduct of business rules are implemented by the different member organisations in a variety of ways : laws ; regulations ; internal rules within a company or institution ; unwritten principles and customs ; case law.

Monitoring and enforcement

26 - The competence of the monitoring authority can be based on the nature of the establishment being controlled (institutional criterion), or on the nature of the activity (functional criterion). It appears, however, that most of the working party members have recourse to both types of control.

27 - Frequently the regulatory functions carried out by central public bodies are combined with those of professional authorities, to whom the task of regulation is often delegated. These functions are also occasionally combined with those carried out by banking authorities.

28 - In certain countries, breaches of rules of business conduct are not subject to sanctions in the strict sense of the word. They result simply in recommendations by the authorities to the parties concerned.

29 - When sanctions do exist, they vary in nature :

- disciplinary sanctions may be taken either against individuals or legal entities ;
- administrative sanctions may be implemented by public authorities or self regulatory organizations ;
- penal sanctions.

and in their content :

- fines ;
- temporary suspension of authorisation to practice an activity ;
- permanent deprivation of authorisation to practice an activity.

V - CONCLUSION

The principles which have been agreed by the working group are contained in the second part of the report. Although IOSCO members have varying degrees of responsibility to regulate conduct of business in their respective countries the working party recommends that they should, in the interests of assisting the development of the international markets, commit themselves to implementing the principles within their own regulatory structures and to promote their wider application, particularly vis à vis other authorities in their own countries.

PART TWO

INTERNATIONAL CONDUCT OF BUSINESS PRINCIPLES

I - DEFINITION OF CONDUCT OF BUSINESS PRINCIPLES

Conduct of business principles can be defined as those principles of conduct which govern the activities of those who provide financial services and which have the objective of protecting the interests of their customers and the integrity of the markets.

These principles are distinct from financial adequacy principles designed to ensure market security. In fact, the two sets of principles complement each other to promote the confidence of investors and the smooth operation of the market.

II - IMPACT OF THE PRINCIPLES PROPOSED BY THE WORKING PARTY

The working party proposes that the Technical Committee establish a set of principles which IOSCO would recommend to be recognised by each member as expressing basic standards of business conduct for financial services firms.

Such recognition would commit the IOSCO member to implement the principles through its regulatory structures and effective supervisory arrangements, and to promote the principles throughout its own country. The member can decide whether to implement them in the form stated by IOSCO or to reflect them in its own principles, adapted to local circumstances.

These principles can also facilitate mutual cooperation in enforcement.

III - PERSONS TO WHOM THE PRINCIPLES APPLY

The proposed principles apply to those firms and their employees and representatives which deal or advise in securities and all kinds of derivative instruments (futures, options, etc).

IV - INTERNATIONAL CONDUCT OF BUSINESS PRINCIPLES

A limited number of comments have been added to individual principles, where the working party believed that it would be useful to illustrate the principle by reference to some rules or obligations which might fall within its boundaries.

1 - HONESTY AND FAIRNESS

In conducting its business activities, a firm should act honestly and fairly in the best interests of its customers and the integrity of the market.

Comment :

This principle includes any obligation to avoid misleading and deceptive acts or representations.

2 - DILIGENCE

In conducting its business activities, a firm should act with due skill, care and diligence, in the best interests of its customers and the integrity of the market.

Comment :

This principle includes any duty of best execution.

3 - CAPABILITIES

A firm should have and employ effectively the resources and procedures which are needed for the proper performance of its business activities.

Comment :

This principle includes any obligation for the firm to have and implement effectively rules and internal procedures for its employees and representatives to make sure that they comply with these principles, including staff dealing rules.

4 - INFORMATION ABOUT CUSTOMERS

A firm should seek from its customers information about their financial situation, investment experience and investment objectives relevant to the services to be provided.

Comments :

This principle includes any obligation to "know one's customer".

This principle is a necessary element in enabling the firm to fulfill any suitability requirements.

5 - INFORMATION FOR CUSTOMERS

A firm should make adequate disclosure of relevant material information in its dealings with its customers.

Comments :

This principle includes any obligation of the firm :

- . to acquire and provide information, including information about risks, needed by the customer to make informed investment decisions ;

- . to provide timely and accurate reports to the customer about business undertaken for or with the customer.

6 - CONFLICTS OF INTEREST

A firm should try to avoid conflicts of interest, and when they cannot be avoided, should ensure that its customers are fairly treated.

Comment :

This principle recognizes that conflicts of interest may be managed, and that proper management to ensure fair treatment of customers may require disclosure, internal rules of confidentiality, or other appropriate methods or combinations of methods.

7 - COMPLIANCE

A firm should comply with all regulatory requirements applicable to the conduct of its business activities so as to promote the best interests of customers and the integrity of the market.