

Jane Diplock AO

Chairman,

Securities Commission New Zealand

&

Executive Committee, International Organization of Securities Commissions

Centre for European Policy Studies

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Who should do what in the global financial architecture ... the art of the possible

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Introduction

I am very pleased to be here in Brussels at the Centre for European Policy Studies (CEPS). I would like to thank Ambassador Peter Kennedy and CEPS' Staffan Jerneck for providing me with this opportunity to address you today. I would also like to thank Mr Bruno Colmant for agreeing to chair the discussion that follows my presentation and Greg Tanzer, IOSCO Secretary General for joining us here from Madrid.



Allow me to briefly outline the thesis of my discussion with you today. I am convinced that the 20th Century global financial architectural solutions are outdated and have been found wanting. They are fundamentally structural solutions. We run the risk of repeating our mistakes unless we look to 21st Century solutions.

The solutions created post 1945 need to be replaced with network solutions reflecting the sort of concepts we see in the internet and developments there. These are not fanciful notions but ones that have already been successfully modelled but in a relatively narrow sphere. What we need is a mechanism by which global concepts or standards can be implemented universally in every jurisdiction around the world.

But before I develop these ideas, I would like to say how much I admire Brussels. It is a beautiful city. Belgium of course is a founding member of the European Union and a country that finds strength in its diversity straddling the physical and cultural boundary between Latin and Germanic Europe. It is a country that has seen many battles over the centuries. Indeed a number of my countrymen have perished in conflicts during two world wars and rest within your borders. Australia and New Zealand both commemorate our fallen on ANZAC day, which incidentally is three days from now.

Most recently New Zealand has developed ties based on technology and intellectual property. We are about to pay homage to one of Belgium's best known international characters – Tintin. Hergé's masterful work will be made into a movie by New Zealand's Academy Award winning director Peter Jackson, of Lord of the Rings and King Kong fame. He along with Steven Spielberg will co-direct several planned movies starting with "The Adventures of Tintin: Secret of the Unicorn" which is currently in pre-production work in Wellington. The special effects and Academy Award winning talent of Weta Workshop will undoubtedly do justice to Hergé's comic book genius.



On a more serious note we move from fiction to fact – Today I would like to discuss the role of key players in the emerging global financial architecture. I want to focus on what is possible, and especially the contribution from IOSCO.

Financial stability is everyone's concern. The underlying foundation of the entire financial system has been exposed to severe risk and it has taken an extreme series of government bailouts and bank acquisitions around the world to attempt to rescue it. The challenges of the current crisis are front of mind for all of us – politicians, regulators, policymakers, regulatory organisations, businesses and investors alike. We are all touched in one way or another.

G20 Leaders recently pledged to do whatever is necessary to restore confidence, growth, and jobs. To grow, any country's economy today relies on a well functioning financial system that enables businesses to borrow and raise capital by issuing securities, and markets where securities can be traded in a fair, transparent and efficient manner. G20 acknowledge that growth cannot return until domestic lending and international capital flows are restored.

So the multi-trillion dollar question remains – how do we build confidence in the financial system, including capital markets?

Capital markets and financial stability

Financial stability is underpinning every effort in finding solutions to the global crisis. It is therefore timely to address issues surrounding capital markets, procyclicality and fair value, to name but a few issues that urgently retain our attention and have been much commented on.

All too often, we see policy-makers and commentators confining financial stability to the domain of banking and prudential supervision frameworks. However, one thing the global crisis has clearly demonstrated is that capital markets form a vital part of the equation.



Much of the harm in the financial sector has come from loss of confidence in markets and intermediaries driven by conduct issues such as conflicts of interest, malpractice, and unethical behaviour.

The global crisis will not be resolved without restoring confidence in capital markets and in the way the various market players conduct their business. Restoring confidence in capital markets requires enhanced securities regulation and supervision in a coordinated fashion at the global level, and independent, strengthened, and well-funded regulators for implementation at the domestic level. It also requires greater coordination between regulators and standard setters in the securities, banking, and insurance sectors, and political will for implementation of international standards.

Strengthening financial regulation – who does what?

As I mentioned earlier, G20 Leaders have pledged to do whatever is necessary to strengthen financial regulation to rebuild trust. In this context, various international bodies and standard setters including the International Organization of Securities Commissions (IOSCO) and the International Accounting Standards Board (IASB) are working within their remit, with their own constituents and with others, to co-ordinate efforts to understand the crisis and find solutions.

The Financial Stability Board

Chairman Draghi has recently noted that "The newly formed Financial Stability Board (FSB) will promote and help to coordinate the alignment of international standard setting activities to address any overlaps or gaps and clarify demarcations in light of changes in national regulatory structures relating to prudential and systemic risk, market integrity and consumer protection, infrastructure, and accounting and auditing".



The formation of the FSB is an extremely important development in global coordination and one which has been welcomed by IOSCO. It is a critical new participant in the global financial architecture and its broadened remit will advance and hopefully accelerate the implementation of global financial standards, amongst the G20 membership and more broadly. The encouragement of the use of the FSAP (Financial Sector Assessment Programme) as a global benchmarking tool by the G20 Leaders and FSB is extremely welcome.

As the international standard setter for securities regulation, IOSCO sits on the FSB and works with its sister organisations responsible for setting standards for the banking and insurance sectors, the Basel Committee on Banking Supervision and the International Association of Insurance Supervisors respectively. IOSCO also works with the IMF, the World Bank, the OECD and the regional development banks, each of which have their own place within the global financial architecture. I might add that the OECD, the IMF, the World Bank, and the Asian Development Bank are affiliate members of IOSCO.

These international organisations all play a vital role in looking at events globally, coordinating and facilitating member nations to find solutions that work beyond their individual jurisdictions.

IOSCO and G20 process

I would now like to expand on what I believe is the pivotal role IOSCO will play going forward. Many of you will be aware of IOSCO and its work as the recognized global standards setter for securities regulation. I have the privilege of chairing the Executive Committee of IOSCO, its governing body. Its member agencies represent 109 jurisdictions, including 81 from emerging markets, and regulate together more than 95% of the world's capital markets. IOSCO leads the thinking on ways to address the challenges for securities regulators amid today's capital market instability.



I am pleased that the G20 Leaders have recognized the significance of IOSCO's role and have endorsed its recent actions aimed at enhancing market transparency and underpinning market integrity. Let me share with you several specific examples. Recent work initiated by IOSCO's Technical Committee includes publication of a consultation report prepared by a taskforce on short selling set up last November. The report proposes principles designed to help develop a more consistent international approach to the regulation of short selling.

Another recent consultation report prepared by the task force on unregulated financial entities deals with hedge fund oversight and recommends regulatory approaches to mitigate risks associated with the trading and traditional lack of transparency in this area.

A taskforce on unregulated financial markets and products is examining ways to introduce greater transparency and oversight to unregulated market segments, such as over the counter markets for derivatives and other structured financial products.

Last month IOSCO published the results of its review of implementation by credit rating agencies of IOSCO's *Code of Conduct Fundamentals for Credit Rating Agencies*. We also published a Note regarding the use of the IOSCO's Code as the basis for international oversight of credit rating agencies. This was sent to both the G20 and the Financial Stability Forum (FSF) and proposes mechanisms by which regulators can help assure adequate cross-border supervision of globally active credit rating agencies.

Finally, IOSCO also published a report which contains recommendations to improve the supervision of commodity futures markets and global regulatory cooperation.

It is my belief that all of this work has been possible at relatively short notice because of the years of work spent developing this unique organisation. Let me expand on this model for a moment.



IOSCO model

IOSCO's wide membership, democratic mode of operation and consensus based standard setting procedure are key elements underlying the Organization's legitimacy and international accountability.

IOSCO's 109 ordinary members are mostly independent governmental regulatory agencies established by statute and with primary responsibility for administering the securities laws of their country. It takes decisions by consensus and makes recommendations for endorsement by the Presidents' Committee where all 109 ordinary members are represented and have an equal say irrespective of the size or development stage of their markets. The international standards IOSCO sets are the result of a thorough process that incorporates public consultation and requires consensus for endorsement. It is my observation that this process provides each regulator with a vested interest in implementing the recommendations that they have collaboratively developed and collectively endorsed.

Mindful of the changing nature of the international financial system in this time of crisis IOSCO's Technical Committee, which is the standards setting arm of the organization, decided earlier this year to invite securities regulatory authorities from Brazil, China and India to become members of that Committee. They were chosen on the basis of the size of their capital markets, the international nature of their markets and the development of their regulatory system and authority and their commitment to IOSCO.

I should note that the set of regulatory principles developed by IOSCO are among the key International Standards and Codes that the G-20 Leaders have committed to seeing implemented and peer-reviewed through the Financial Sector Assessment Programme. This programme



conducted jointly by the IMF and the World Bank consists of a comprehensive assessment by international experts of the financial regulatory framework of countries who voluntarily submit to it. The assessments help identify the strengths and vulnerabilities of a country's financial system and seek to determine how key sources of risk are being managed. This helps governments to prioritize policy responses and ascertain developmental and technical assistance needs. In the ten years since the programme has been established, about three-quarters of IMF and World Bank member countries have completed or requested an initial assessment. In addition IOSCO has a programme of assisted assessments of its Principles under which 15 IOSCO members have taken assessments of their securities regulation against the Principles with the help of experienced regulators from other IOSCO members.

The G20 has recommended all G20 members submit to an FSAP and that other countries either engage in a self-assessment or an FSAP using the IOSCO Principles.

This brings me to the *IOSCO Objectives and Principles of Securities Regulation* and its related IOSCO Assessment Methodology which together provide the benchmark against which the securities sector is assessed. These key documents were endorsed by the 109 member Presidents Committee.

I believe the IOSCO Principles align well with G20 Leaders' aspirations. The Principles recognise that securities regulation should have three objectives: the protection of investors; ensuring that markets are fair, efficient and transparent; and the reduction of systemic risk. To help achieve these objectives, IOSCO has developed 30 broad Principles for securities regulation for full implementation in the regulatory framework of every member jurisdiction. I should say these Principles do <u>not</u> constitute rules and regulations aimed at achieving convergence between regulators. They are rather a set of benchmark standards against which any jurisdiction is able to measure and align their own laws in a manner consistent with their own priorities, traditions, market developments and conditions and legal frameworks.



To keep pace with market developments and regulatory thinking, the Principles are organic and updated regularly. Last year, IOSCO launched a review process undertaken by a taskforce of experts from regulatory agencies of developed and emerging markets and representatives from the IMF and the World Bank.

The FSAP process which I mentioned earlier, and G20 Leaders commitment to this, significantly reinforces IOSCO's standard-setting role in respect of the securities sector. IOSCO will continue its active and continuous policy dialogue with institutions such as the IMF and the World Bank which has a key role in assessing compliance with the standards set by IOSCO and other similar bodies. In addition it gives impetus to IOSCO's own assessment programme which is focused on the securities sector and uses experienced regulators from IOSCO members as assessors.

I strongly believe that implementation by all jurisdictions of the IOSCO Principles will help reduce the scope for regulatory arbitrage the G20 Leaders seek to achieve.

National implementation of global solutions

While global solutions and coordination by the FSB are very important, implementation remains a domestic concern.

The pace of the spread of systemic risk through the banking and capital market systems of the world heralded a call for a global solution. Some called for a global regulator to be set up. Some called on the IMF to take on this role, but the difficulties posed by the tension between a global solution and national jurisdictional remit of regulators and supervisors was starkly revealed.

There are a number of possible ways in which global ideas can be implemented in each jurisdiction. To be viable any solution needs to use the domestic legal framework and allow political concerns to be addressed.



Despite the high level of coordination provided by the FSB it's my personal view that it remains unlikely that national authorities will cede jurisdiction to any global regulator. Yet, the tension between globalisation and domestic implementation has never been more obvious.

It's here that I believe we should look to 21st Century solutions. Just as the internet is not one central brain but a vast network, so regulation underpinned by appropriate global standards, implemented in every jurisdiction and audited by external experts (such as through the FSAP process) could provide a global virtual "super regulator".

The answer lies, to my mind, in a framework already modelled by IOSCO. In 2005 IOSCO decided that its *Multilateral Memorandum of Understanding concerning Consultation and Cooperation and the Exchange of Information* (MMOU) should be implemented in every one of the 109 member jurisdictions by 2010. In 2005 it may have appeared fanciful that the exchange of information requirements outlined in the IOSCO MMOU would be implemented in all member jurisdictions by 2010 or be promised to be. Strict auditing needed to be undergone to ensure a jurisdiction had complied before signature was allowed. Some jurisdictions had banking secrecy laws they needed to change, others had other difficult legislative amendments, yet it looks as if the goal will be achieved. It has been a Herculean task. Today the principles reflected in the IOSCO MMOU are implemented in the legislation of 52 jurisdictions with 21 more promising to do so.

This is a model which could work more broadly.

Accounting convergence

Another important model is explicit in the current journey towards globally harmonized accounting standards. The convergence of IFRS and US GAAP will provide one global set of high level standards. It is vital that the political exigencies of the crisis do not undermine or



derail this vitally important process. There is a risk of a race to the bottom if political interference disrupts or is perceived to disrupt the independence of standards setters and the due process these standards deserve. The risk that investors doubt the validity of accounts could undermine the confidence essential for the recovery. To my mind acceleration of the road map to convergence of IFRS and US GAAP is essential.

Mutual recognition

I believe that another similar but different way forward to the recovery is that provided by mutual recognition of regulatory frameworks between jurisdictions that can effectively enhance the liquidity and resilience of markets.

Mutual recognition does not require the adoption of identical legislation. Rather than envisaging standardized model frameworks across jurisdictions, it allows domestic laws and regulations to reflect national imperatives while providing the capacity for cross-border cooperation and enforcement.

Let me give you an example from my own jurisdiction. In June 2008, New Zealand and Australia saw the coming into force of a regime of mutual recognition of securities offerings. This allows issuers to offer securities in both Australia and New Zealand using the same offer documents with minimal additional obligations. The benefits sought by such arrangements are to promote investment between the countries concerned, enhance competition in capital markets, reduce costs for businesses and increase investor choice. The results to date are encouraging, with several offers having been made across Australasia.

To work effectively, mutual recognition requires coordinated responses and consistent approaches to regulating cross-border transactions. As a first step to achieving mutual recognition, there must be agreement on a common basis of principles on which to assess the



effectiveness of foreign regulations and the work of the foreign regulator. The IOSCO Principles provide such a basis. Another important element of any mutual recognition arrangement will, of course, be the ability for regulators to share information and cooperate to engage in effective enforcement across borders. The IOSCO MMOU provides a fundamental tool to achieving this.

One great strength of mutual recognition framework is that it provides for an effective enforcement framework which is critical if network solutions are to be effective.

Mutual recognition provides a framework to leverage on the strength of markets around the world – bringing diversity, driving best practice and efficiency and opening up a multitude of opportunities for the local financial services sector, business and consumers.

As a result, it is likely that a market value will emerge for participation as may be the case for the IOSCO MMOU. In turn, policy-makers will wish to ensure that the benefits of greater liquidity flow to their domestic markets. It will be the demand from market participants which is likely, in my opinion, to provide the political will in jurisdictions to undertake these exercises.

Significant discussions on mutual recognition arrangements were commenced by a number of jurisdictions prior to the crisis. These discussions appear to have stalled but should be recommenced as this network solution will provide benefits to market participants and investors.

The challenges for recognition agreements between jurisdictions which do not have close ties in other spheres may be difficult, but the success of the IOSCO MMOU demonstrates that members of IOSCO can, and do, work together even though the foreign policy of the various governments may differ.

Other models



Jacques de Larosière's recent proposals for cross-border supervision of financial institutions have elements of structural and networked solutions. He proposes a European Systemic Risk Council comprising 27 EU central banks and the European Central Bank plus insurance and securities supervisors to provide an early warning system for detecting stability risks.

Critics have suggested that this was the opportunity for a single pan-European supervisor but that is not his proposal. Once again a network solution has emerged. This system of supervision will provide over time a more specific coordination role for the Committee of European Securities Regulators and the Committee of European Banking Supervisors but on my reading direct supervision of firms and implementation of regulation standards will rely on national regulators. I look forward to seeing the future development of these proposals over the coming months, as the results in the EU will be keenly observed by others thinking about their regulatory structure.

Risks of protectionism

I believe comity in the regulatory space should become even more important as a result of the crisis and should extend through mutual and unilateral mechanisms. The arrangements will vary but underpinning them will be adherence to the IOSCO Principles and signature of the IOSCO MMOU.

Just as there have been concerns in relation to the global free trade agenda that the financial crisis may precipitate a return to trade protectionism, similarly any suggestion of regulatory protectionism should be resisted. There have been enormous strides made in the global regulatory reach reflecting the global developments of markets, and it would be extremely disappointing if this success was undermined. Any move in this direction would also be likely to



increase costs for global financial players at the very time that they are trying to successfully emerge from the financial crisis.

Going forward

In the past few years, IOSCO has developed through its international standard-setting activities into one of the fundamental institutions in the global financial architecture. Going forward, reduction of systemic risk and attainment of financial stability is a key objective of securities regulation and in that respect falls squarely within the remit of IOSCO.

IOSCO has adopted a more operational approach through promoting both the full implementation of IOSCO's 30 broad Principles and widening of the network of IOSCO MMOU signatories. Our initiative of confidential dialogue with uncooperative, under-regulated jurisdictions has yielded very positive results, with one of the jurisdictions concerned having since changed its laws to be able to sign on to the IOSCO MMOU.

The G20 process most recently supports these achievements and provides further impetus for taking stock of lessons learnt from this crisis to review existing standards and where needed, initiate standards where gaps need to be filled and put in place mechanisms that will ensure that this situation is not repeated.

IOSCO has started a process of reviewing its strategic direction for beyond 2010. It is indeed timely to start identifying our vision beyond this decade as we learn the lessons from the global financial crisis. This will lead to greater focus on issues of stability in capital markets.

It seems there is no doubt that there will be the need for IOSCO to contribute significantly towards strengthening confidence in the global financial markets and to do so, we might need to find new and different mechanisms for global oversight. There is also no doubt that reduction of



systemic risk, efficient, well-functioning markets and investor protection will remain at the heart of our mission.

Conclusion

As a trans-national and consensus based organisation, IOSCO is equipped to bring to the national level global solutions. It has already succeeded in implementing a significant global initiative at domestic level, through the IOSCO MMOU. Over the years, IOSCO has built the trust and relationships that are necessary for national jurisdictions to embed global solutions. It offers a unique and workable model, which includes providing technical assistance where required.

The regulatory solutions for the 21st Century are definitely going to be significantly different from those of last century.

While there will be greater coordination and cross-sectoral work at the global level, it will remain the obligation of national regulators and policy-makers to bring about change on the ground. It is my belief that a series of networked solutions will be developed and these solutions will require the cooperation of all major players in the global financial architecture as well as commitment at national jurisdictional level. To be effective these solutions will require high sets of robust global standards constantly updated to reflect market changes, effective enforcement capacity across borders and watchful eyes and actions across the world on stability issues. IOSCO is very much part of these 21st Century solutions.

Thank you.