

IOSCO Challenges in a Dynamic Global Market

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Introduction

Thank you for your invitation to speak today. I welcome the opportunity to outline the major challenges facing IOSCO and its member regulators throughout the world, including of course the Securities and Exchange Board of India.

India is one of over 100 countries represented within IOSCO, or to give the organization its full name, the International Organisation of Securities Commissions. As you might know, the Securities and Exchange Board of India is an active member of IOSCO's Emerging Markets Committee and of its Asia-Pacific Regional Committee.

It is a particular pleasure for me, as Chairman of the Executive Committee of IOSCO, to speak at a gathering such as this.

India is one of the highest growth economies and capital markets in the world. Your friends in the Asia-Pacific region, and your colleagues in IOSCO, watch with intense interest India's progress in reforming capital market structures and rules. We are certainly familiar with the broad issues in your debate over demutualization of securities exchanges and the need to avoid conflicts of interest. We wish you well for a successful resolution of those issues. IOSCO has recently issued a consultation paper on the regulatory oversight of demutualised exchanges. Your contribution and comments in this area will be very welcome.

IOSCO Background

Let me introduce IOSCO to you, before addressing the particular topic of my speech on IOSCO's challenges in international capital markets.

IOSCO was established 23 years ago and is now the international standard-setter for securities market regulation. Our members are committed to cooperation in setting regulatory standards that promote sound markets worldwide. And they are committed to cooperation in the implementation of those standards, and to mutual assistance on matters of information exchange and regulatory enforcement. Together, we have made substantial progress in identifying issues that threaten market integrity and in encouraging individual regulators to take appropriate steps, both within their home jurisdictions and across borders in cooperation with others.

Securities regulation has three core objectives. These are set out in the *IOSCO Objectives and Principles of Securities Regulation* (IOSCO Principles) formally adopted by the Organisation in 1998. These objectives are:

- the protection of investors;
- ensuring that markets are fair, efficient and transparent; and
- the reduction of systemic risk.

These objectives, supported by 30 core Principles, are the foundation for all IOSCO work programmes and, as I will explain further soon, we want to see them clearly expressed in the regulatory framework of every IOSCO member.

As an international body, IOSCO has a particular strength in the breadth and depth of its membership. Our member regulators from over 100 countries together oversee more than 90% of the world's securities markets. And through IOSCO we have developed an extraordinary ability to build consensus on issues, and to make effective change in regulatory standards and practices worldwide. IOSCO has a small General Secretariat based in Madrid but it also works through broad-based representation of member regulatory agencies in standing committees that enable members' diverse views to be reflected in new standards, benchmarks and reports.

Full credit must go to individual member regulatory agencies that actively support IOSCO and grapple with the most important of regulatory challenges. I particularly commend those who are moving promptly to sign the *IOSCO Multilateral Memorandum of Understanding on Consultation, Cooperation and Exchange of Information* (IOSCO MOU). I take this opportunity to warmly congratulate the Securities and Exchange Board of India on becoming one of the signatories to the IOSCO MOU. The IOSCO MOU is a critical initiative for IOSCO and I will talk more on this later.

IOSCO's other major strength is its standing in the global financial community. Its work is recognized by the International Monetary Fund and World Bank, and we collaborate closely with peer standard-setting bodies in the global banking and insurance sectors. Since the mid 1990s, IOSCO, the Basel Committee on Banking Supervision and the International Association of Insurance Supervisors have formed the so-called Joint Forum for coordinating regulation across the securities, banking and insurance market sectors.

Distinctions between these markets, or at least between the activities of firms operating in one or more of the markets, are increasingly blurred. The Joint Forum has established regulatory guidelines, for instance, on credit risks transfers and on risk management around the outsourcing of services by financial sector firms. In recent years, IOSCO has also been closely involved with the Basel Committee on Banking Supervision as it has formulated the new capital adequacy and risk standards that are now embodied in the international Basel II accord for banking supervision.

Market Developments

The Joint Forum and all other aspects of IOSCO's work programme are ongoing efforts to keep pace with hectic growth and increasing complexity in the world's capital markets, and to strengthen those capital markets for the greater good of the world economy.

Consider some basic facts:

- The global stock of financial assets is now around 136 trillion US dollars, a figure one and a half times higher than it was just 10 years ago. (This from McKinsey Global Institute).
- In 2004, new capital raising worldwide was up 40% from the previous year. (Data from the World Federation of Exchanges).
- Cross-border investment is increasing rapidly, mostly concentrated into emerging markets which now account for around 12% of world stock market capitalization. Today, there are more exchange listed companies in emerging markets than in all OECD member countries. (This according to Standard & Poor's Fact Book).
- New investment entities are increasingly part of the global market, most notably hedge funds which now are estimated to have around 1 trillion US dollars under management (Data from the IMF Global Financial Stability Report).

From the IOSCO perspective, such growth, complexity and global integration of markets bring major challenges. We certainly applaud developments that will fuel economic growth and prosperity across the world. But we must address any associated loss of fairness, efficiency and transparency in markets; any reduction in protection for investors; or any growth in systemic risks that goes unseen or unmanaged. These concerns are, of course, aligned to the core objectives of the IOSCO Principles.

With growth, complexity and global integration, we see particular risks of deliberate market wrong-doing and financial fraud. Corporate scandals of recent years, most prominently, Enron in the United States and Parmalat of Italy, have fuelled that concern, not just for IOSCO but for regulatory agencies and legislators worldwide.

In 2004, IOSCO set up a Task Force to examine the issues revealed by Parmalat and other scandals, and to identify any patterns of regulatory failure that could undermine market integrity and investor confidence. The resulting report was a very thorough piece of work. The Task Force report, issued a year ago and entitled *Strengthening Capital Markets Against Financial Fraud*, identified seven areas where the scandals did, indeed, raise regulatory issues. They are:

- corporate governance, including the role of independent directors;
- audit standards and auditors, including their independence;
- disclosure requirements of the issuers of securities;
- transparency in bond markets;
- the role and obligations of market intermediaries;
- the use of complex corporate structure and special purpose entities;
- independence and integrity of information analysts.

On reflection, the list contained no surprises. IOSCO and its member regulators were already well aware of these as issues where appropriate regulation is critical, and where absence of adequate regulation could undermine integrity and confidence. The Task Force concluded that widespread consensus already existed on most of the issues.

What was not clear was the extent to which principles and standards were actually implemented and enforced by individual regulators. The report went on to highlight the critical importance of comprehensive implementation as capital markets become more integrated and more global. Highlighted also was the need for effective cross-border cooperation between regulators. Without this, their best efforts at regulatory oversight and enforcement may count for little in a global market.

Strengthening Capital Markets Against Financial Fraud, along with all our other, ongoing work on regulatory standards and regulatory cooperation, has led to a prioritization of the challenges now facing IOSCO. There are three challenges, and I will devote the rest of my time today to discussing them.

Principles Implementation

As mentioned, the IOSCO Principles have become the foundation for all IOSCO activities since 1998. The 30 core IOSCO Principles encompass:

- the responsibilities and powers of national market regulators;
- the importance of cooperation between them;
- the basic requirements of securities issuers and market intermediaries; and
- the role of self-regulatory organizations.

The Principles also deal with collective investment schemes and the working of secondary markets.

It is important to note that the IOSCO Principles are high-level and do not set down tight prescription for any particular market. The intent has been to establish clear guidelines for all markets, while enabling legislators and regulators to implement these guidelines in their own particular economic, political and legal circumstances. Over recent years, many IOSCO members have diligently worked at implementation, and at measuring existing regulatory rules and practices against the IOSCO Principles.

New Zealand is a good case in point. Our securities regulation was subject to audit in 2003 under the Financial Sector Assessment Programme of the IMF, a programme that uses the IOSCO Principles and the related IOSCO Assessment Methodology for this purpose. The resulting IMF report concluded that in respect of New Zealand securities markets, most of the IOSCO Principles had been implemented. Gaps were identified in respect of the regulation of financial intermediaries and of collective investment schemes.

These are now being addressed in legislation before the Parliament in Wellington. As a result, we will have comprehensive new measures against the manipulation of markets and against insider trading, with the Securities Commission acquiring new powers of

enforcement in key areas. Once the legislation is enacted, New Zealand expects to have achieved full implementation of the IOSCO Principles. That said, capital markets are inherently dynamic. They are fast growing, and becoming more complex and more integrated globally. The task of ensuring the IOSCO Principles are adequately reflected in regulatory rules and practices will be ongoing.

The Task Force on issues of financial fraud highlighted the importance of the full spectrum of the IOSCO Principles being implemented by IOSCO's membership. The Organisation's first challenge, therefore, is to drive forward processes of implementation as widely as possible. This can be achieved principally through IOSCO's technical assistance programmes. These assistance programmes are coordinated by the IOSCO General Secretariat and tailor-made to each requesting IOSCO member. Typically, IOSCO provides an expert for assisting members in carrying out self-assessments of how the IOSCO Principles are implemented and, if wished, for devising action programmes to address any identified gaps. This is done by applying the IOSCO Assessment Methodology as a benchmarking tool to identify the regulatory "gaps" that need addressing in each jurisdiction.

Principles implementation is a particular issue in some emerging markets. The Organisation will increasingly put resources into IOSCO assisted self-assessments and processes for upgrading regulation where gaps are identified. Emerging markets have the most to gain from demonstrated implementation of the IOSCO Principles as it signals that a market is operating with internationally-accepted standards for investor protection, and for fairness and efficiency. These are vital ingredients for building and maintaining international investor confidence which, in turn, is vital for attracting and retaining capital in emerging market economies.

We also promote the implementation of the IOSCO Principles through the ongoing development of standards and benchmarks in particular areas of regulation. Currently, we are working on issues raised by the emergence of hedge funds and by the demutualization of stock exchanges worldwide. Last month, IOSCO issued consultation papers in each of these areas to clarify the issues and identify what standards and benchmarks might usefully be established in support of the IOSCO Principles.

IOSCO has also published codes of practice for securities analysts and credit rating agencies, and principles for the regulation of external auditors of public companies – an area of particular concern relating to corporate scandals. We followed this up with a survey of members in 2004. We wanted a snapshot of the progress made in this area, and a picture of the various structures and processes being used to ensure integrity in the independent auditing of public companies.

Among the 57 jurisdictions surveyed, implementation was relatively high. For instance, 82% had one or more formal bodies that had some responsibility for overseeing audit processes within companies. There were some significant gaps relative to the standards advanced by IOSCO, but overall we have seen substantial improvements in the level of auditor independence and the assurance of such independence since we and others put a

spotlight on this area five years ago. The survey and ongoing debate about some aspects of auditor regulation are an example of how IOSCO pushes for the implementation of the IOSCO Principles and standards as widely as possible.

Unregulated Jurisdictions

With the globalisation of capital markets, enforcing securities regulation increasingly requires securities regulators to request information from foreign counterparts and to cooperate in enforcement cases. This is sometimes very difficult to achieve at the operational level, for various reasons. There are markets that are plainly under-regulated, and others in which the appropriate authorities are either unable or unwilling to cooperate with foreign counterparts. These markets pose our second major challenge. The Technical Committee of IOSCO, one of those standing committees I mentioned earlier, has a programme to identify and prioritize jurisdictions in both these categories.

As markets everywhere become more integrated, under-regulated or uncooperative jurisdictions are more of an issue for the global financial system. The Technical Committee is looking at these markets in terms of their size, the nature of their transactional flows and their general significance in the global financial system. IOSCO is increasing its efforts to encourage and support these jurisdictions to improve their regulatory framework and cooperate internationally.

Multilateral Cooperation

International cooperation between regulators is an increasingly dominant theme across all areas. In general, regulators see the advantages, and indeed, the necessity of being able to exchange information across borders and assist each other with regulatory oversight and enforcement. They see critical questions about regulatory effectiveness in the face of market developments.

The Task Force against financial fraud included this blunt statement in its report: *“The increasingly global nature of modern capital markets means that, even if implementation of international regulatory principles and standards were universal, the benefits of these principles and standards could be defeated if financial regulators and law enforcement agencies lack the ability to take effective enforcement action, to share enforced related information and coordinate investigations.”*

Obviously, this points to the third major challenge for IOSCO: How to facilitate timely and efficient cooperation between members and specifically, how to embed the *IOSCO Multilateral Memorandum of Understanding on Consultation, Cooperation and Exchange of Information* in the global financial system. The IOSCO MOU is of critical importance to IOSCO.

It was developed and endorsed in 2002. Last year, IOSCO members took a momentous step in requiring all IOSCO members to become full signatories of the IOSCO MOU by 1 January 2010, or to have at least joined its Appendix B. For some regulators,

substantial work is required to secure the legal authority and organisational capabilities that are necessary for them to become full signatories. Under the IOSCO MOU, national regulators must be sufficiently empowered within their home jurisdictions to gather and exchange certain types of information on an equal basis with regulators in other jurisdictions. Appendix B is a list of regulators committed to achieving the legal and organisational capabilities they require for full signatory status.

The IOSCO vision is for all securities regulators to engage across borders whenever appropriate for regulatory oversight and enforcement in a seamless, effective manner. Securities regulators will surely need to do so in a world of integrated securities markets. The Securities and Exchange Board of India and the Securities Commission of New Zealand are two of 30 regulatory agencies to have so far become full signatories to the IOSCO MOU. We do have an emerging international network for regulatory cooperation and that network can be very effective.

As an example, the Securities Commission of New Zealand is currently pursuing a high profile insider trading case. The case involves sales of shares during 2002 in a stock exchange listed company that was then operating New Zealand's national rail network. The Commission used the IOSCO MOU in its pursuit of former insiders now living in either the United States or Europe. Matters have benefited greatly from the cooperation of regulators in these jurisdictions. To date, US-based defendants have agreed to pay more than US\$3.5 million in compensation. Proceedings continue against two other defendants. For us, this is a landmark case on critical issues of insider trading. We believe our ability to enforce regulations that are of an internationally-high standard and to reach across borders, when necessary to do so, is fundamental for maintaining and increasing investor confidence in the capital markets of New Zealand. Clearly, the same can be said for confidence in the markets in other Asia-Pacific nations.

There are, nonetheless, substantial challenges for IOSCO in extending coverage of the IOSCO MOU over more member jurisdictions, especially among the emerging markets. In late 2005, IOSCO members from the Asia-Pacific region were surveyed on their views on international cooperation and their approach to the IOSCO MOU. All those responding to the survey agreed on the importance of international cooperation and information exchange. Most indicated that they already cooperate with other regulators, although mostly under bilateral arrangements.

The survey confirmed that insufficient legal powers for regulators to gather and exchange information are a significant impediment to more IOSCO members becoming full signatories to the IOSCO MOU at this stage. The survey also confirmed the value that our members see in IOSCO assistance programmes to help overcome these impediments. These programmes are an area of increasing focus for the Organisation.

Concluding Comments

Clearly, IOSCO has a full agenda, driven in large part by the growth, increasing complexity and global integration of securities markets. I have outlined three areas of major challenge – the broader implementation of our core IOSCO Principles of securities regulation; the targeting of under-regulated or uncooperative jurisdictions in the global financial system; and the building of an efficient international network for cooperation between regulators under the IOSCO MOU. The Securities and Exchange Board of India is a valued and active member of this Organisation, particularly in the Asia-Pacific region.

I conclude with an observation made last year by the Task Force against financial fraud. It examined the issues raised by corporate scandals and helped set IOSCO on the strategic direction we now follow for enhanced securities regulation worldwide. The Task Force noted: *“It takes the constant vigilance of all stakeholders – issuers, investors, auditors, analysts, market operators, market intermediaries, regulators and other enforcement agencies – to minimize market misconduct.”*

In my own words, market integrity and investor confidence must be the constant concern not just of regulators, but of all market participants. I am confident this is a challenge accepted by issuers, investors, auditors and others in our audience here today!

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