ICSA
INTERNATIONAL COUNCIL of SECURITIES ASSOCIATIONS

June 8, 2007

Ms. Tillie Rijk
IOSCO General Secretariat
Calle Oquendo 12
28006 Madrid
Spain

Re: Comments on IOSCO Consultation Report, *An Overview of the Work of IOSCO's Technical Committee*

Dear Ms. Rijk:

We are writing on behalf of the members of the International Council of Securities Associations ("ICSA") which is composed of the trade associations and self-regulatory associations active in the world's major securities markets.[1] We would like to thank the members of IOSCO's Technical Committee and the IOSCO Secretariat for the work that they have done to produce the *Overview of the Work of IOSCO's Technical Committee* ("the Report") that was released in March of this year. We welcome the opportunity to comment on the Report.

ICSA's members appreciate IOSCO's significant body of work in recent years on a range of matters that are vital to the efficiency and sound operation of financial markets, especially in a cross-border context. In an increasingly global capital market, it makes sense for discussions of regulatory policy to be placed as far as possible at an international level. The work program for the period ahead, as detailed in the Report, covers an equally important range of issues that are of key strategic significance to the securities industry. Finally, the publication of the Report itself is most welcome as the industry needs to understand the concerns of regulators if it is to respond effectively to those concerns, and to take account of them in its own planning. The Report will help to

[1] The members of the International Council of Securities Associations (ICSA) represent and/or regulate the overwhelming majority of the world's equity and fixed income markets. ICSA's objectives are: (1) to encourage the sound growth of the international securities markets by promoting harmonization in the procedures and regulation of those markets; and (2) to promote mutual understanding and the exchange of information among ICSA members.

foster increased communication between IOSCO and the industry, and we hope that the exercise will be repeated at suitable intervals in the future.

We have structured our comment letter to address the specific issues that were raised in the Report. Specifically, this letter responds to the Technical Committee's request for comment on: (1) opportunities for IOSCO to promote just, efficient and sound markets; (2) market risks that might warrant regulatory intervention; (3) regulatory failures (for example instances where regulation is not effective or where sectoral or national regulations are inconsistent or incomplete); (4) IOSCO's overall program of activities; and (5) specific ongoing activities of IOSCO. Our comments on these specific issues are the following:

## 1. Opportunities for IOSCO to promote just, efficient and sound markets

IOSCO is clearly already playing a very important role in promoting just, efficient and sound markets both nationally and internationally. However, ICSA members believe that there are a number of areas where IOSCO has not yet focused its attention and which could be important for IOSCO's overall objectives. Specifically, ICSA members suggest that IOSCO could:

### 1.1 Establish a structured dialogue with market participants

ICSA members consider that a structured dialogue between IOSCO and the industry is crucial, given the rapid pace of change that is taking place within the securities industry on a worldwide basis. Ultimately, regulators and industry participants share the same objective, which is to foster the sustainable growth of the capital market in the most efficient and effective manner possible while protecting investors and ensuring market integrity. We believe that a structured and effective dialogue between IOSCO and the industry will contribute toward achieving that common objective. We commend the Technical Committee for having taken the initiative to begin the process of establishing a more structured relationship with the industry and look forward to the evolution of that dialogue over time.

### 1.2 More actively promote regulatory convergence

This is an extremely important issue since financial markets are increasingly integrated on a global basis while regulatory regimes remain largely national. As a result, regulations are often different and sometimes contradictory, which imposes substantial costs and inefficiencies on the international capital market. IOSCO's work in developing standards and principles for securities regulators as well as its work in other areas – such as international accounting standards – has been critical in laying the groundwork for increased regulatory convergence. The existing bilateral and multilateral agreements between securities regulators in different jurisdictions also help to mitigate the inefficiencies introduced by different regulatory approaches in an increasingly integrated and global capital market. Despite all of the work done to date, however, firms active in the international capital market are still faced with significant costs arising from the need to comply with different sets of regulations when operating on a cross-border basis.

ICSA members understand that achieving agreement about regulatory convergence among IOSCO members is extremely difficult due to the nature of the organization and the heterogeneity of its membership. However, despite these important structural constraints, ICSA members believe that some work can still be done by IOSCO to promote a greater degree of regulatory convergence.

Specifically, ICSA members believe that IOSCO could encourage regulatory convergence by continuing to focus on the development of high-level global principles rather than specific rules.[2] These principles could then be implemented by individual regulators in accordance with their existing legal and regulatory regimes. ICSA members also believe that IOSCO could promote regulatory convergence by encouraging its members to adopt principles-based and risk-focused regulatory regimes that have clearly defined objectives. The reliance on principles-based and risk-focused regulatory regimes with clearly defined – and in many cases similar – objectives in different jurisdictions should encourage similar policy responses, thereby promoting greater efficiency in the international capital market.

### 1.3 Develop and promote principles for "better regulation"

Over the past several years governments and regulators in a number of jurisdictions have identified and in some cases adopted measures intended to improve the efficiency of their regulations.[3] The "better regulation" initiatives announced to date have included a variety of measures such as a commitment to reduce red tape and unproductive rules, to regulate as lightly as possible, to consult more widely before regulating, and to make regulations straightforward and accessible. In a few jurisdictions, regulators have also undertaken a thoroughgoing and systematic review of their underlying regulatory philosophy as part of their commitment to better regulation.

The adoption of "better regulation" initiatives in a variety of jurisdictions reflects the understanding that regulation has a critical impact on the efficiency of markets and, by extension, on overall economic performance. ICSA members believe that this issue is important to securities market regulators everywhere, since regulators in

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[2] ICSA members acknowledge and are grateful for the important work that IOSCO has already achieved in this area, including its promotion of convergence in the international accounting system.

[3] At the national and international level, a number of governments in Europe as well as the European Commission have adopted "better regulation" initiatives. In addition, regulatory authorities for financial services in Australia, France, Ireland, the Netherlands and the UK have all announced and in some cases already begun to implement "better regulation" initiatives. At the provincial level, the British Colombia Securities Commission had pursued a particularly active "principles based" agenda for a number of years.

almost all jurisdictions are charged with protecting the well-being of consumers. While the mandate of consumer protection can be interpreted quite narrowly, at a broader level it clearly includes measures to promote overall market efficiency since more efficient financial markets should promote economic growth and thereby the well-being of consumers.

Given the importance of this issue, ICSA members would encourage IOSCO to develop and promote principles for "better regulation" that would, at some point in time, be incorporated into IOSCO's *Objectives and Principles of Securities Regulation*.

From the point of view of ICSA members, any set of principles for better regulation would encourage regulators to carry out rigorous economic analysis prior to implementing new regulations, so that they could determine if the contemplated regulations were necessary and, if so, if the regulations would be the most cost effective method for resolving the problems that have been identified.[4] In addition, principles for better regulation would also encourage the development of regulatory policies that were targeted, proportionate and risk-based and, where possible, that relied on stable principles rather than detailed and prescriptive rules. Finally, principles for better regulation would encourage regulators to develop effective consultation programs that allowed market participants to influence the design and implementation of regulatory policy (see paragraph 1.4 below).

1.4 Develop and promote principles for regulatory consultation

A consultation program that encourages a frank and open exchange of views between regulators and market participants on an ongoing basis is an important element of any program of "better regulation", as noted above. However, effective consultation is also important in its own right, as it can improve the efficiency of regulatory policy by: (1) allowing financial market participants to better understand the goals and instruments of those policies, thereby greatly strengthening the potential for cooperation between regulators and market participants; and (2) enabling market participants and the general public to provide feedback on proposed regulations, thereby improving the decision making process for regulators while also reducing the risk that new policies will have unintended, and negative, consequences for financial markets.

ICSA members welcome the fact that IOSCO itself has developed and follows a comprehensive consultation program for its own work. However, many individual IOSCO members still do not have effective consultation programs that allow market participants in those jurisdictions to influence the design and implementation of

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[4] For further clarification regarding ICSA's views on better regulation, see ICSA's *Principles for Better Regulation*, October 2006. See also Section 3 of this letter.

regulatory policy. To remedy that situation, ICSA members would encourage IOSCO to develop principles for regulatory consultation that it would promote to all IOSCO members. In time, these principles could be incorporated into IOSCO's *Objectives and Principles of Securities Regulation*.

An effective consultation program, from the point of view of ICSA members, would include either formal or informal "pre-consultation" with industry representatives prior to the design of new regulations as well as measures that would aim to ensure that the actual consultation process includes input from the full range of interested parties.[5] This would require that regulators: (1) encourage input from all relevant parties and (2) allow adequate time for each consultation. Finally, an effective consultation policy would ensure that the feedback received by regulators during the consultation process would be, to the greatest extent possible, incorporated into the regulations that were the subject of the consultation.

1.5 Promote financial and investor education

ICSA members believe that financial and investor education is increasingly critical in today's world, since educated consumers who are able to make informed judgments regarding their investments are more able to promote their own financial well-being while also contributing to higher levels of national savings and a more efficient allocation of capital. Moreover, since educated consumers are able to make more informed choices about financial products and investments, financial and investor education should help regulators and private sector market participants alike to better achieve the critical goal of protecting investors while also helping to build investor confidence in securities markets. To promote investor education on both a national and international level, ICSA members produced and endorsed a set of *Principles and Best Practices for Investor Education* in early 2004. Many ICSA members also participate in the International Forum for Investor Education (IFIE), a non-commercial, private sector organization whose primary objective is to improve investor education on a worldwide basis. We understand that IOSCO will be jointly sponsoring a seminar on investor education with IFIE later this year. ICSA members strongly support that initiative and, given the importance of financial and investor education at both the national and international level, would encourage IOSCO to continue to devote resources to this specific issue.

## 2. Market risks which might warrant regulatory intervention

There are a large number of areas which might warrant regulatory intervention. Many of these, however, are specific to individual jurisdictions and would not necessarily have relevance on a cross-border basis. However, one area that is

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[5] For further clarification on ICSA's view of regulatory consultation practices, see ICSA's *Statement on Regulatory and Self-Regulatory Consultation Practices,* October 2004.

relevant on a cross-border basis and which concerns nearly all ICSA members is the ongoing evolution of exchanges and other market infrastructure providers. As IOSCO's final report on *Regulatory Issues Arising from Exchange Evolution* noted, over the past decade almost all of the world's major exchanges and many smaller exchanges have demutualized and, in many cases, are involved in an ongoing process of consolidation.[6] ICSA members understand that consolidation among exchanges and other market infrastructure providers should in theory bring with it a variety of benefits, including more integrated and liquid markets and lower costs for users. However, there is a possibility that a relatively small number of exchanges will emerge as dominant players in a number of markets, leading to the potential for monopolistic pricing and other forms of uncompetitive behavior, which in turn would have a negative effect on capital formation and the overall efficiency of the economy.

These developments, including changes in the ownership structure and consolidation among exchanges, are extremely important for the securities industry since most of the activity in the industry involves on and off-exchange trading. Demutualization and consolidation among exchanges also raises important public policy concerns, due to the potentially negative impact of those developments on competition, market integrity and economic efficiency. This concern was expressed in the IOSCO report cited above which, among other measures, recommended that:

> Regulatory authorities should consider competition issues that may arise in connection with the evolution of exchanges … where such evolution impacts market integrity, efficiency or investor protection.[7]

ICSA members strongly agree with that recommendation and suggest that IOSCO continue to monitor this issue closely. Moreover, in cases where exchanges and other market infrastructure providers do have dominant or monopolistic market positions, ICSA members believe that appropriate policy measures should be sought to promote effective competition for those entities. If such a policy response is not possible or practical, ICSA members would encourage the relevant authorities to ensure that appropriate governance structures and rules are in place so that the interests of users, the investing public and the economy as a whole are protected. Such a process has already been initiated in the EU, where the European Commission has requested that the industry develop and adhere to an ambitious code of conduct aimed at enhancing transparency and increasing competition in clearing and settlement. ICSA members have also developed a set of *Principles for the Governance of Market Infrastructure* which are intended to provide a framework for the implementation of governance arrangements at market infrastructure providers that would reflect the unique characteristics of the industry and ensure accountability and transparency for owners, users and regulators. Since the process of consolidation among exchanges transcends national boundaries, ICSA members believe that it

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[6] Technical Committee of IOSCO, *Regulatory Issues Arising from Exchange Evolution: Final Report*, November 2006.

[7] Ibid, page 42.

would be appropriate for IOSCO similarly to promote the further development of a framework of good practices for the governance of exchanges and other market infrastructure providers, perhaps encompassing the ICSA Principles.

## 3. Regulatory failures

From the point of view of ICSA members, there are several types of regulatory failures that are particularly relevant: (1) failures that arise because the regulation is not addressing an identified market failure;[8] (2) failures that arise when there is an identified market failure but the regulation is not the most efficient way to correct the problem and therefore the costs of the regulation are higher than the benefit; and (3) failures that arise when there is an identified market failure but the regulation is not effective and therefore the net benefits of the regulation are not as great as they could be. This last form of regulatory failure would apply, for example, when regulations for investor protection and market integrity are not sufficient to prevent misselling and other forms of inappropriate behavior. It would also apply, for example, where the costs arising from duplicative national regulatory regimes are greater than necessary

In order to help regulators to identify existing regulatory failures and help to prevent the emergence of new regulatory failures, ICSA members would encourage IOSCO to promote “better regulation” policies and efficient consultation programs among its members, as noted above. A better regulation program would encourage regulators to carry out rigorous economic analysis prior to implementing new regulations so that they could determine if the contemplated regulations were necessary and would be the most cost effective method for resolving the problems that have been identified. Similarly, an effective consultation program can improve the efficiency of regulatory policy by providing input to regulators from market participants while also strengthening the potential for cooperation between regulators and market participants.

In addition, as was also noted above, ICSA members would encourage IOSCO to work toward international regulatory convergence whenever possible. This is important since firms active in the international capital market are faced with different and sometimes contradictory regulations for the same issue in different jurisdictions. While these differences are understandable, and may be extremely difficult to mitigate in the short term, their continued existence imposes a cost on the international capital market which will only increase as national financial markets become more integrated with one another.

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[8] Market failure is defined here to encompass all situations where a market left to itself does not allocate resources efficiently.

## 4. IOSCO's overall program of activities

IOSCO's role within the international financial market has clearly changed over the past several years due to the globalization of domestic financial markets and the need for regulators to have greater communication and understanding among themselves. ICSA members believe that IOSCO's importance and work program will continue to expand in the future, as a result of the continuing globalization of financial markets. Therefore, ICSA members would like to offer several suggestions related to IOSCO's overall program of activities, which are detailed below.

### 4.1 Better prioritize its work program

It appears to ICSA's members that IOSCO's work program continues to be influenced by a variety of factors, including concerns of some individual national regulators as well as broader concerns that affect a larger number of jurisdictions. ICSA members believe that it would be useful if IOSCO were to set clearer priorities for its work program, publicize those priorities so that the industry was aware of what they were, and ensure to the greatest extent possible that all future projects were consistent with those priorities, except in cases when emergency responses were needed. ICSA members would also suggest, as noted above, that IOSCO's priorities include a focus on encouraging regulatory convergence, better regulation and consultation.

### 4.2 Increase transparency and accountability

IOSCO has clearly become much more transparent in the way it consults with market participants over the last few years. Currently, however, there is little clarity as to whether IOSCO's newer principles and standards are being applied by individual IOSCO members and whether those principles and standards are effective or not. ICSA members recommend that IOSCO regularly survey its members to determine the extent to which IOSCO's principles and standards[9]: (1) are applied by individual regulators; and (2) add value to the regulatory process in individual jurisdictions. This process would be similar to, and complementary with, the current process whereby the implementation of IOSCO's *Objectives and Principles of Securities Regulation* in different jurisdictions is assessed. In the interest of enhanced transparency and accountability, the results of those surveys and/or assessments should be made public.

### 4.3 Clarify the relationship between IOSCO and other standard setting bodies

Over the past several years, IOSCO has become the leading international standards setter in the field of securities regulation. However, at the same time standards are

[9] Other than those detailed in the *Objectives and Principles of Securities Regulation,* which are already reviewed by the IMF in its country assessments.

being issued by other international and supra-national bodies such as CESR, the BIS and others, as well as by national standard setters (e.g. the proposal by Germany's DIN regarding international standards for credit rating agencies). It would be extremely useful for market participants if IOSCO could clarify its relationship with other standard setting bodies. Moreover, in the interest of market efficiency, it is imperative that IOSCO's standards are consistent with the standards issued by other international and national bodies, and vice versa.

## 5. Specific ongoing activities of IOSCO

We would like to offer some comments on some of IOSCO's current and exploratory work, specifically the following:

### *a. Price formation on fragmented markets*

ICSA members understand the need for IOSCO to monitor developments in securities trading given the impact of technological innovations on markets everywhere and the effect of new regulations in many jurisdictions, such as the MiFID in Europe and Regulation NMS in the U.S.

However, ICSA members believe it is important to remember that financial markets are always subject to cycles of competition, fragmentation, and consolidation. This is particularly the case at the current time, due in large part to ongoing regulatory and technological changes that are affecting all aspects of the securities market. As a result of these changes, some markets are becoming more fragmented while there is greater concentration taking place elsewhere.[10]

Given the rapid pace of current market and technological developments, ICSA members believe that it may be too early for IOSCO to carry out any substantive work on the efficiency of price formation on fragmented markets.

Moreover, ICSA members would also note that many market participants and scholars believe that a multiplicity of markets is a sign of innovation and, as long as competition on those markets is genuinely open and fair, is not a problem that requires regulatory intervention. In addition, the market fragmentation that has already taken place may not have had as negative an impact on market liquidity and the price discovery process as feared. For example, largely due to a series of important technological developments, price information can now be consolidated from a variety of markets and venues and smart-routing technologies can ensure that orders are routed to the venue providing the best result. In these circumstances, inappropriate regulatory intervention could negatively impact the pace of technological innovation and the development of markets, which in turn would have an adverse effect on market efficiency and economic growth.

[10] This is the case in the U.S., for example, where Reg NMS has concentrated the order flow.

Given the extremely fluid nature of financial markets, ICSA members believe this is an important area where a structured and effective dialogue between IOSCO and market participants could be extremely useful in order to facilitate an exchange of views about these critical market developments.

*b. Direct access to exchanges and other markets*

Our previous comments regarding price formation on fragmented markets (see above) are relevant here. More generally, we would note that direct access to exchanges and other markets raises differing policy issues depending on the type, size and scale of the markets concerned. In addition, ongoing technological and regulatory changes are clearly facilitating disintermediation, although at this stage the extent of disintermediation is fairly limited. One specific area that IOSCO may wish to consider is the extent to which it might become increasingly difficult for regulators to achieve regulatory outcomes against a background of significant disintermediation, particularly when market regulation obligations have been placed mainly on intermediaries.

*c. Managing conflicts of interest at market intermediaries*

ICSA sent a comment letter in response to IOSCO's consultation paper entitled, *Market Intermediary Management of Conflicts that Arise in Securities Offerings*. As noted in that letter, given the wide differences that exist between regulatory and legal regimes in different jurisdictions, ICSA members believe that IOSCO should focus on promoting general principles for managing conflicts of interest rather than specific rules. Moreover, if IOSCO were to develop global principles for market intermediary management of conflicts of interest that arise in securities offerings, we would expect that IOSCO would consult separately with the industry on the design and content of those principles.

*d. Point of sale disclosure and customer suitability*

This is an important issue as there is a wide variation in disclosure and suitability rules between individual jurisdictions. Indeed, customer suitability rules appear to be non-existent in some IOSCO member jurisdictions. In these circumstances, ICSA members would encourage IOSCO to undertake work that would result in greater cross-border consistency (and eventually harmonization) between disclosure and suitability requirements in different jurisdictions. In addition, ICSA members would specifically encourage IOSCO to examine the use of technologically enabled disclosure for "point of sale" information delivered to retail customers and others, in place of rules that require delivery of such information on a hard copy basis.

*e. Impact of new technology*

In general ICSA members believe that IOSCO's interest in this area is quite useful. However, we would note that the discussion in the Report regarding this issue may be too restricted than is necessary since it focuses primarily on record keeping. We would suggest that precisely because of its critical impact on financial markets and market participants, regulators need to carefully study and understand the directions in which technology is developing in order to evaluate whether those changes have undermined, or are likely to undermine, the effectiveness of their existing regulatory approaches. Since technological changes are responsible for a significant share of the market restructuring that is currently taking place and are likely to continue to play the same role in the future, a close and continuing study of new technology should help regulators gain an understanding of the ways that their current policies and approaches may have to be adapted.

*f. Elements of regulation for hedge funds*

As noted above, ICSA members believe that IOSCO should encourage its members to develop a coherent, principles-based and risk-focused regulatory framework that is applied consistently across the financial sector to meet clearly defined objectives, rather than relying on instrument-specific or institution-specific regulations that are developed in isolation. ICSA members also believe that IOSCO should encourage its members to take into account the benefits as well as the risks that accompany financial innovation and the role that market discipline can play in controlling risks to public objectives. On the specific issue of hedge fund regulation, ICSA members generally believe that there would need to be a compelling rationale for special regulation of different types of investment funds. Instead, ICSA members support the work done to date by governments and regulators in a large number of jurisdictions promoting a principles-based approach toward hedge funds and other large pools of capital that relies on both market discipline and strong regulatory oversight. ICSA members would encourage IOSCO to leverage off of the existing work that has already been carried out by various regulators and governments in this area. ICSA members also take note of the recommendations recently issued by the Financial Stability Forum regarding the need to strengthen market discipline for hedge funds.

*g. Soft commissions and incentives*

ICSA sent a comment letter on IOSCO's consultation paper, *Soft Commission Arrangements*, in mid-March. As noted in that letter, ICSA members strongly agree with the main conclusion of that Report, which is that it is too early for IOSCO to develop global principles for soft commissions and incentives.

*h. Private equity*

This is clearly a very important issue for the entire international financial market. However, as noted above in reference to the regulation of hedge funds, ICSA members believe that IOSCO should encourage its members to develop a coherent, principles-based and risk-focused regulatory framework that is applied consistently across the financial sector to meet clearly defined objectives, rather than relying on instrument-specific or institution-specific regulations that are developed in isolation. Again, the need for special regulation of private equity compared with other forms of investment would also need to be established.

In closing, ICSA members would once again like to thank the members of IOSCO's Technical Committee and IOSCO's Secretariat for the work that they did in preparing this Report. We welcome the opportunity to comment on the Report and look forward to further discussing the issues contained in the Report with IOSCO members.

Sincerely,

Kun Ho Hwang, Chairman,
ICSA Advisory Committee
and Chairman, Korea Securities
Dealers Association (KSDA)

Marilyn Skiles
Secretary General
ICSA