ICSA
INTERNATIONAL COUNCIL of SECURITIES ASSOCIATIONS

RULE MAKING AND REGULATION IN FINANCIAL MARKETS: PRINCIPLES FOR BETTER REGULATION

For all ICSA members, well-judged regulation is essential in promoting the proper functioning and integrity of financial markets, the prevention of financial crime, and the appropriate protection of market users and investors.[1] At the same time, inappropriate or excessive regulation undermines markets and harms the interests of consumers, businesses and economic growth more generally. So finding the right balance is most important. Recognising this, governments, regulators and market participants in a number of jurisdictions have identified and in some cases already adopted a working philosophy of better regulation.[2] ICSA members strongly support this development.

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.[3]

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1. The members of the International Council of Securities Associations (ICSA) represent and/or regulate the overwhelming majority of the world's equity, bond and derivatives 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. A list of ICSA members is attached to this document.

2. 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, national regulatory authorities for financial services in Australia, France, Ireland, the Netherlands and the UK have all announced "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.

3. In this document the term 'regulator' is intended to cover all bodies that are authorized pursuant to law to play a role in: (1) formulating rules, regulations and policies for financial services firms and the employees of those firms, agents and independent contractors, financial markets and/or financial

This work has now gone far enough for it to be possible to distil many of the most valuable elements of such an approach. Based on the various "better regulation" initiatives now in effect, ICSA has drawn together ten *Principles for Better Regulation* for discussion with regulatory authorities and market participants.[4] They build on ICSA's other work on transparency and consultation in regulatory policy making and put forward basic elements of both the philosophy and good practice that sound intervention in financial markets requires.[5]

The *Principles for Better Regulation* are based on the understanding that regulation is only one of several ways of responding to a problem and that it is an imperfect tool. Since regulation will typically impose costs, it can only be worth undertaking if there is a demonstrable market failure, other remedies are likely to be less effective, and the benefits of intervention are likely to outweigh the costs.[6] Similar considerations should also be applied when considering whether and how to handle misconduct by firms or individuals.

In light of these considerations, ICSA members have endorsed the following *Principles for Better Regulation*:

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services products; and/or (2) licensing and supervision of the activities of such firms and their employees, agents and independent contractors, markets and products.

4. The *Principles for Better Regulation* promote increased efficiency in financial markets and therefore are entirely consistent with the core objectives of securities regulation as outlined in IOSCO's *Objectives and Principles of Securities Regulation*. The *Principles for Better Regulation* also complement and amplify the IOSCO *Principles*, as they take into account the underlying economic rationale for regulatory intervention in a market economy and detail some of the considerations needed to ensure that intervention achieves its desired effect.

5. See ICSA's *Statement on Regulatory and Self-Regulatory Consultation Practices (2004).*

6. In financial markets there are three types of problems that may need to be regulated if market forces alone are unlikely to be successful in correcting those problems over a reasonable timeframe: (a) externalities that arise when the costs and benefits of engaging in particular activities do not accrue solely to the direct buyers and sellers; (b) insufficient competition that enables certain users to exert monopolistic or monopsonistic market power; and (c) information asymmetries that arise when one party to a transaction has an informational advantage over another party in that transaction.

PRINCIPLES FOR BETTER REGULATION

1. *Establish first whether there is a significant market failure or financial misbehaviour arising from firms' conduct, risk management or relations with consumers, which is not appropriately addressed by existing regulations and their enforcement and which is unlikely to be mitigated over a reasonable period of time by market forces.*

   Setting a robust burden of proof for regulatory action to deal with a market failure or financial crime helps to prevent inappropriate or excessive regulation, which tends to distort markets. As important is recognising the degree of failure which should be accepted – whether of markets or of behavior – since risk, uncertainty and insolvency are unavoidable in a healthy, dynamic and innovative market. In other words, the goal of zero-failure is both undesirable and unattainable.

2. *Where market failure or misbehaviour has been established and is unlikely to be mitigated over time by market or other forces or actions, rigorous analysis should be employed, using cost-benefit techniques to the extent possible, in order to determine whether the expected benefits of any contemplated action, regulatory or other, would outweigh the costs or disadvantages.*

   Regulatory intervention in a market economy is only economically justified when it can be demonstrated that a market failure exists and the benefits of any new regulation are materially greater than the cost. While cost-benefit and impact analysis are still imperfect tools, their use requires regulatory policy-makers and market participants to confront directly the fundamental questions of whether a measure is worthwhile, and demands considered and reasoned judgements as to whether one kind of measure is likely to be better than another

3. *When considering what to do, regulatory policymakers should consider the full range of appropriate responses to a problem before turning to legislative or regulatory measures.*

Even when it is determined that there is a market failure, regulatory intervention may not be the best solution. Instead, it may be far more efficient for regulators and government authorities to encourage appropriate responses through other measures. In most contexts the range of possible measures is likely to include several of the following:

(a) Effective monitoring and enforcement of existing regulations;

(b) Improving the operations of the market**,** for example by introducing measures to stimulate competition and the provision of more information or requiring better disclosure;

c) Establishing an ombudsman and/or other forms of complaint procedures; compensation schemes; legal and court processes, e.g. tort actions; and providing insurance mechanisms;

d) Stimulating self-regulation of various kinds; and

e) Joint initiatives between regulatory authorities, who fix the principles and regulations, and market participants and their representatives, who can often provide the detailed guidance market participants need and which is most appropriate to market realities.

4. Regulations should be targeted, proportionate and risk based.

To have the best achievable impact with fewest side effects, regulation should be no more complex or wide-ranging than the risks that are to be mitigated. In order to achieve that objective, regulations should be:

a) **Proportionate,** and in keeping with the scale and complexity of the problem;

b) **Targeted,** and designed to meet specific objectives, whether by sector, product, market participant or region;[7] and,

c) **Risk-based,** in other words appropriate to the probability of a problem occurring as well as its potential severity.

5. *Where possible, regulations should stimulate rather than restrict competition.*

In a variety of situations, well-judged regulations will have the effect of restricting competition in financial markets. This may be the case, for example, when licensing or educational requirements are imposed. However desirable in themselves, such measures are barriers to entry and can often restrict the number of entrants to a specific business or profession. Where regulations materially restrict competition, their impact should be reviewed periodically or when requested by market participants.

6. *As far as practical, regulators should rely on stable, principles-based regulations.*

A regulatory regime that is prescriptive, detailed and hard-wired from top to bottom cannot adapt easily to changing market realities. However, a regime based on stable principles can be provided with the capacity to revise operational detail quickly, and thus to track and match changing market needs and circumstances closely. To achieve the greatest contribution to efficiency and competitiveness under the principles-based approach, regulators and market participants must develop trusting and

7. For example, retail markets generally require more detailed rules than wholesale markets. However, as the barriers between markets fall, regulators may sometimes impose retail standards on wholesale markets. A targeted policy, instead, would be directed only at retail investors regardless of the markets in which they are active.

constructive relationships and the regulatory framework must be able to evolve freely to produce the concrete guidance needed at any point in time.

7. *All regulations should be reviewed from time to time to examine whether they and the market failure to which they were initially directed are still relevant and, if so, whether the measures should be amended, simplified or abolished.*

Financial markets are dynamic while regulations, generally, are not. Therefore, it can happen that regulations that were introduced at one point in time in order to correct a specific market failure are no longer necessary or appropriate. For that reason, regulators should from time to time review existing regulatory policies, taking into consideration the views of market participants, in order to determine whether they are still needed, how effective they are, and whether they should be amended or eliminated.

8. *Market participants and the general public should be able to influence governments and regulators in the design and implementation of regulatory policy through an effective and structured consultation process.*

An effective and structured consultation process contributes to efficient capital markets through a variety of channels. First, by allowing market participants and members of the public to react to proposed regulatory policy, consultation improves regulators' decision making processes while also reducing the risk that new policies will have unintended effects on financial markets; or will fail to achieve a given regulatory target. Second, consultation makes regulatory policy more effective because it allows market participants to understand better the goals and instruments of those policies, strengthening the potential for cooperation between regulators and market participants. As a result, an effective and structured consultation process improves the quality and efficiency of the rules and regulations adopted.

9. *If it is necessary to issue new regulations at extreme speed, those regulations should have an automatic sunset clause that sets a firm deadline for considering whether to abandon the measure or replace it with something permanent, following a structured and effective consultation with the industry.*

In emergencies, regulators may find themselves forced to work with extreme speed and unable to follow normal processes for regulatory policy formulation. In such circumstances, any "emergency" regulations should contain a specific sunset clause to ensure that the regulation does not stay in effect for an extended period of time without a thoroughgoing review by regulators and market participants.

10. *Where two or more regulators operate in a given jurisdiction, there must be proper coordination between those organizations.*

In many jurisdictions, more than one regulatory authority is responsible for regulating all or some part of the financial markets. In such circumstances, in order to avoid harming the market it is important that regulators work together to ensure that there is no conflict or duplication in their current or prospective regulatory activity. Moreover, national and international regulators should ensure that regulatory initiatives are allocated to the appropriate national and international level recognising that some regulatory solutions are best determined and delivered at a local level so as to reflect different backgrounds and retain the benefits of diversity and constructive competition. Other regulatory areas will, of course, benefit from the provision of a "level playing field" and getting the balance right between harmonisation and diversity is important to better regulation.

The following associations are members of ICSA:

Association of Capital Market Intermediary Institutions of Turkey (TSPAKB)
Australian Financial Markets Association (AFMA)
Bond Exchange of South Africa (BESA)
French Association of Investment Firms (AFEI)
International Capital Market Association (ICMA)
Investment Dealers Association of Canada (IDA)
Italian Association of Financial Intermediaries (Assosim)
Japan Securities Dealers Association (JSDA)
Korea Securities Dealers Association (KSDA)
London Investment Banking Association (LIBA)
NASD
Securities and Financial Markets Association (SIFMA)
Swedish Securities Dealers Association (SSDA)
Taiwan Securities Association (TSA)