

**IMMEDIATE
ATTENTION**

SM/02/121

April 19, 2002

To: Members of the Executive Board

From: The Secretary

Subject: **Experience with the Assessments of the IOSCO Objectives and Principles of Securities Regulation Under the Financial Sector Assessment Program**

Attached for the information of the Executive Directors is a paper, prepared jointly by the staffs of the Fund and the World Bank, reviewing the experience with the assessment of securities regulation on the basis of the Objectives and Principles of Securities Regulation issued by the International Organization of Securities Commissions (IOSCO). This paper is part of the review of the experience with assessing financial sector standards. Earlier papers included the Experience with Basel Core Principles Assessments (SM/00/77, 4/12/00), Review of the Experience with the Assessments of Implementation of the IMF Code of Good Practices on Transparency in Monetary and Financial Policies (SM/00/269, 12/1/00), and the Experience with the Insurance Core Principles Assessments Under the Financial Sector Assessment Program (SM/01/266, 8/21/01).

It is expected that this paper will be posted on the Fund's external website. If no objections are received by the close of business on Thursday, April 25, 2002, the paper will be posted.

Questions may be referred to Mr. Petersen, MAE (ext. 38390) and Ms. J. Elliott, MAE (ext. 38804).

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

THE WORLD BANK

**Experience with the Assessments of the IOSCO Objectives and Principles of Securities
Regulation under the Financial Sector Assessment Program**

Prepared by the staff of the International Monetary Fund and The World Bank

Approved by Stefan Ingves and Cesare Calari

April 18, 2002

Contents	Page
Executive Summary	3
I. Introduction	4
II. Securities Sector and Supervisory Approaches.....	6
A. Securities Markets Development and Financial Stability	6
B. Regulation and Supervision of Securities Markets	7
C. IOSCO and the Principles	11
III. Principles Assessment Process and Findings.....	13
A. Assessment Process.....	13
B. Preconditions Assessment.....	14
C. Assessment of Principles.....	15
General observations.....	15
Main findings and assessment recommendations	16
Emerging market country and developed country comparisons.....	23
Principles assessment and IOSCO self-assessments.....	24
Implications for financial sector soundness and development	24
IV. Follow-up from Assessments	25
A. Authorities Response	25
B. Technical Assistance	25
V. Enhancing the Assessments	26
Improving Principles and assessment methodology	26
Improving the process.....	27
Securities markets and vulnerabilities	27

VI. Conclusion	27
----------------------	----

Text Tables

1. Completed or on-going IOSCO Principles assessments	5
2. IOSCO Assessments: Percentage shares of observance with the IOSCO Objectives and Principles of Securities Regulation	17

Boxes

1. IOSCO Objectives and Principles of Securities Regulation	12
---	----

EXECUTIVE SUMMARY

1. The International Organization of Securities Commissions (IOSCO) Objectives and Principles of Securities Regulation (the Principles) form an essential part of the standards and codes work undertaken in the Financial Sector Assessment Program (FSAP). The Principles set a standard against which a country's practice of regulation and supervision of securities markets is assessed. The assessment while enhancing the country's understanding of its own system in the context of international standards and to the overall understanding of the strengths and weaknesses in financial sector supervision, will benefit from continuing work on the criteria for implementation of the Principles and from a deeper understanding of the linkages between securities regulation and macro-economic vulnerabilities. Enhancements to the operational aspects of the FSAP will also improve the quality of the assessments and lead to their greater integration into the main FSAP findings.
2. This paper undertakes an analysis of 22 completed IOSCO assessments, which include assessments of both developed and emerging market countries. The analysis considers the results of the assessments, the contribution of these assessments to the main FSAP findings, the experience of the assessors and the experiences of the authorities. The process has been a valuable one—in addition to identifying areas for reform, the assessments also act to increase awareness of international best practice, creating an opportunity for self-evaluation and priority-setting in the assessed jurisdiction. The paper concludes that further strengthening of the IOSCO Principles assessment process would enhance the FSAP.
3. While the size and complexity of securities markets influence the regulatory approach adopted, it is clear from the analysis that implementation of securities law and regulations is the greatest challenge facing assessed countries. Implementation is often a capacity issue for regulators and one that could, in the case of emerging and developing markets, benefit from technical assistance. The accommodative language of the Principles, wherein implementation is not expressly defined, also highlights the need of the Bank and Fund to continue our collaborative work with IOSCO to further develop guidance in this area.
4. Finally, an analysis of the role played by assessments in the findings of vulnerabilities in the financial sector reveals that additional work is needed to draw connections between weaknesses in securities market supervision and vulnerabilities.

I. INTRODUCTION

5. **The health of an economy increasingly relies on orderly, efficient and well-regulated securities markets.** The increased complexity and growth of securities markets has created demand for enhanced knowledge and understanding of the regulation of these markets and the connection between regulatory deficiencies and other areas of the financial sector and the economy as a whole.

6. **In recognition of the role played by securities markets in the financial sector, the FSAP frequently includes an assessment of the strengths and weaknesses of the supervision and regulation of securities markets.** Such assessments are done in countries where the securities market is considered by the mission to be material to the financial sector or in certain circumstances where, although the securities markets might not be systemically significant, an assessment might assist the authorities in properly gauging the progress of their regulatory reforms. Of the 45 completed or on-going FSAPs, 33 include an assessment of securities markets supervision and regulation. FSAPs generally also include a discussion of capital markets more broadly, and for developing and emerging market countries attention is paid to development issues in this area.

7. **The assessments have been undertaken under the rubric of the IOSCO Principles.** An IMF Code of Good Practices on Transparency in Monetary and Financial Policies, 1999 (MFP Transparency Code) and Anti-Money Laundering assessment may also be undertaken in conjunction with the Principles assessment. In some countries, a detailed assessment of clearing and settlement systems has also been undertaken under the Committee on Payment and Settlement Systems (CPSS)/IOSCO Recommendations for Securities Settlement Systems (the Recommendations).¹

8. **This paper examines the experience with the Principles assessments in the FSAP, including a discussion of progress to-date and the future work to be done.** The paper is based on an analysis of completed Principles assessments, feedback from assessors, mission chiefs and the authorities. The paper identifies the role the Principles play in the FSAP context and analyzes the usefulness of the assessments in identifying vulnerabilities arising from regulation of securities markets as well as their usefulness in identifying development concerns. In addition, the paper identifies areas in which securities regulators could improve practices and areas in which more guidance on international standards is required. Finally, the paper identifies on-going work being done at the Bank and Fund to meet the challenges presented.

¹ A discussion of the experience with the MFP Transparency Code and the CPSS/IOSCO Recommendations for Securities Settlement Systems, 2001 (Recommendations) assessments is beyond the scope of this paper.

9. **A presentation of these findings will be made to IOSCO—thus providing crucial feedback to the standard setter on the use of the Principles and their role in our evolving understanding of financial sector issues.** This will be the first third-party feedback IOSCO receives on the Principles and will form a useful basis for our on-going discussions with IOSCO regarding guidance on implementation of the Principles.

10. **The remainder of the paper is organized as follows:** Section II identifies supervisory approaches in the context of the development of securities markets and examines the evolution of the Principles; Section III discusses the use of the Principles in the FSAP, the assessment process and draws out the themes and issues evident in the assessments; Section IV notes the follow-up activities; Section V posits enhancements to the assessment process and; Section VI offers concluding statements.

Table 1. Completed or on-going IOSCO Principles assessments
(as of end of January, 2002)

FSAP Missions	Date of First Mission	World Bank/IMF staff	External Expert
<i>Completed</i>			
Armenia	09/2000	x	
Canada	10/1999		x
Czech Republic	11/2000		x
Estonia	03/2000	x	
Ghana	07/2000	x	
Hungary	02/2000	x	
Iceland	11/2000		x
India	03/2000	x	
Ireland	02/2000		x
Israel	09/2000	x	
Kazakhstan	02/2000	x	
Mexico	03/2001		x
Poland	07/2000	x	
Senegal	11/2000		x
Slovenia	11/2000	x	
<i>Ongoing</i>			
Argentina	02/2001	x	
Bulgaria	10/2001		x
Costa Rica	10/2001	x	
Croatia	04/2001	x	
Finland	02/2001		x
Gabon	05/2001	x	
Georgia	05/2001	x	
Korea	10/2001		x
Latvia	02/2001	x	
Lithuania	09/2001	x	
Luxembourg	10/2001		x
Nigeria	12/2001	x	
Philippines	10/2001	x	
Sri Lanka	10/2001	x	
Sweden	10/2001	x	
Switzerland	06/2001		x
Tunisia	02/2001	x	
Uruguay	11/2001	x	
Total	33	22	11

II. SECURITIES SECTOR AND SUPERVISORY APPROACHES

A. Securities Markets Development and Financial Stability

11. **Securities markets are a major component of the financial sector and as such play a central role in the stability and development of economies; an understanding of the role of securities markets and their regulation in the context of the FSAP and the work of the Bank and Fund more generally is therefore essential.** The role of securities markets—which can be said to include public financing through debt, equity and derivatives instruments—in the economy has increased globally in the past twenty years. Capitalization of equity and bond markets now dwarfs the aggregate assets of the banking system in industrialized countries and substantially exceeds global GDP.² In many industrialized countries, savings in the form of securities investments now exceed savings in the form of deposits. There has been an increased exposure of households, corporations and financial institutions to securities markets through primary and secondary markets investment and through trading of risk in financial markets.

12. **Well-developed securities markets offer an alternative source of intermediation, enhancing efficiency in the financial sector through competition and acting to reduce pressure on the commercial banking sector.** Securities markets intermediate savings into finance for public companies, provide a mechanism for the efficient valuation of assets and diversification of risks, create liquidity in financial claims, and efficiently allocate risks. In the process, securities markets reduce the cost of capital, making larger economy-wide savings and investment possible.

13. **Investor confidence is the key to fostering strong markets. Without sound regulation and effective supervision such confidence can evaporate causing disruption and instability.** Such disruption can, moreover, lead to contagion in the region or in other markets. Securities investment confers an intangible property right, the value of which is subject to fluctuation and in which the investment can be rapidly liquidated, unlike more traditional investments such real estate or deposits. Non-insider investors have to be assured that they are not at a disadvantage to management or controlling shareholders to the extent that the value of the securities is distorted. Since the value of securities relies heavily on information, securities regulation has to address the asymmetry of information if the market is to function properly.

² According to the World Federation of Stock Exchanges, world stock market capitalization at the end of 2000 amounted to \$31 trillion, up from US\$17.1 trillion at the end of 1995. The market value of the bonds listed in the exchanges at the end of 2000 totaled US\$16.5 trillion, only slightly higher than the value at the end of 1995. However, there are large disparities between mature and emerging markets. Stock market capitalization in emerging markets accounted for 6.8 percent of the total in 2000 (statistics for 2001 are not yet available).

14. **The evaporation of investor confidence can be sudden and far-reaching even in deep, well-developed markets and can, in more fragile economies, cause a devastating reversal of capital flows.** In circumstances where investors begin to question the efficacy of the regulatory system's approach to the asymmetry of information, this can have a serious impact on market values. Securities regulatory regimes address these concerns through regulation of issuer disclosure and accounting and audit standards. Intermediaries serve as a means to verify information through the provision of impartial advice, sound underwriting and analysis—all of which are designed to instill in the investor a sense of confidence in accepting the information in the market—and thus are also regulated. Markets in turn must promote fair trading practices, so that investors are confident that they are receiving the best price possible and to ensure that price discovery in the system is fair and reflects the true value of the security.

15. **Securities markets have a central role in fostering the effectiveness of market discipline.** Transparency and sound regulation of the markets create conditions favorable to the development of good governance practices—with adequate and accurate information, markets will provide incentives to corporations and financial institutions to employ sound practices.

16. **An assessment of the supervision and regulation of securities markets has formed an integral part of the FSAP and in the context of an assessment of the overall health of the financial sector.** The connections between sound regulation of the securities markets and supervision of the entirety of the financial sector continue to be explored within the FSAP, while regulators, economists and other professionals in the field continue to develop a better understanding of the role of sound regulation in financial stability.

B. Regulation and Supervision of Securities Markets

17. **Historically, regulation of capital markets developed in large part as a result of market failures—most famously following the 1929 U.S. equity market crash.**³ The massive economic disruption caused by the sudden sharp drop in equity prices prompted governments to begin regulating issuers of securities, market intermediaries and the markets themselves. Governments sought to protect investors from losses by addressing the lack of disclosure to investors that led to improper valuation of securities and by addressing the relationship between intermediaries and investors. Over time, securities regulation has responded to more and more complex market issues. Securities regulation now typically

³ Although laws governing the sale of securities or investment firms existed in the U.S. and elsewhere prior to the 1929 crash, the 1933 Securities Act and the 1934 Securities and Exchange Act that resulted from the crash represented the first comprehensive approach to securities regulation in a form that would be recognizable to securities regulators today—taking the regulation of issuers, markets and market intermediaries beyond the realm of corporate law and into a new framework.

addresses a range of institutions, such as issuers, market intermediaries, investment funds and marketplaces. Each institution presents different risks to the financial system and to the investor and is therefore approached differently, requiring the securities regulator to employ a variety of skills and knowledge. In addition to prudential regulation of financial institutions, securities regulators must also understand market and sale conduct, financial disclosure of public companies, and a wide-variety of financial products.

18. **The Principles state that the three objectives of regulation are: protection of investors; ensuring markets are fair, efficient and transparent and; reduction of systemic risk.** While regulators in industrialized countries have traditionally focused their efforts on investor protection, more attention has been given in recent years to efficiency of markets in light of the increased permeability of national borders and growing competition for liquidity in securities markets. Increasing market integration and growth in cross-border activities, derivatives trading, financial conglomeration and exposure to securities markets on the part of insurance, pension and banking institutions, also require better understanding of systemic issues.

19. **Rule-making, licensing, approvals, inspections, investigations and enforcement actions are the key tools of securities regulators.** The Principles require that the regulator have at a minimum the authority to create rules, full licensing and delicensing authority over intermediaries, the right to review and approve offering documents for issuance of securities and full enforcement authority to pursue inspections, investigations and enforcement actions for non-compliance with securities laws.

20. **Regulation of market intermediaries focuses on the financial health of the intermediary, with a view to preventing market disruption or client losses in the event of an insolvency.** Prudential regulation of market intermediaries involves the setting of minimum capital, insurance requirements and capital adequacy standards. The Principles require the capital requirements to reflect the risks associated with the activities undertaken by the intermediary—for example, underwriting commitments and margin lending to clients. Prudential standards are monitored through off-site reporting requirements, audit requirements and on-site examinations. The Principles requires that regulations govern exit of intermediaries so that systemic risk and investor loss are properly contained in the event of a wind-up—in many jurisdictions, investor compensation schemes act as the primary mechanism for handling such matters.

21. **Internal control standards for market intermediaries ensure the protection of client assets from fraud and intermediary insolvency.** Client assets should be protected from general creditors in the event of an insolvency; this is achieved through segregation, record-keeping, reporting and audit requirements. On-site examinations and reporting are used as a mechanism for monitoring compliance with these standards.

22. **Regulation of market intermediary conduct in relation to clients is designed to protect investors against the conflicts of interest implicit in the market intermediary's role.** Business conduct regulation involves standards for record-keeping and client

documentation such as trade confirmations and account statements. It also involves disclosure of risks and conflicts of interest to clients—for example, when the market intermediary is an insider in a company whose securities are being recommended to the client. Clients are further protected with proficiency and supervision requirements that ensure that the internal organization of the intermediary is conducive to a high standard of professional conduct.

23. In some jurisdictions, stock exchanges or other self-regulatory organizations (SROs) may have direct regulatory responsibility for the regulation of market intermediaries. Where SROs are used, the Principles ask that such use be appropriate to the size and nature of the market and that the regulator have direct oversight responsibility for the SRO. Appropriate supervision of SROs ensures that inherent conflicts of interest are properly managed and that SROs undertake regulation fairly and effectively.

24. Issuers of securities—companies that are financed through public offerings of equity or debt instruments—are regulated indirectly through requirements for disclosure related to these offerings. The Principles require that disclosure standards be set and enforced for offering documents (usually prospectus requirements which include requirements for audited financial statements). Accounting standards and standards for the auditors must be of high quality. The Principles also stipulate that rules should be in place to requiring timely disclosure by the issuer of material events, for example events that will have an impact on share value. Regulators in large markets also impose continuous disclosure requirements on issuers.

25. Issuer regulation also focuses on the rights of non-insider or minority shareholders. An important aspect of this is the designation of insiders, generally officers and directors and large shareholders in the corporation, and disclosure and effective monitoring of insider transactions. Take-over rules and rules related to related party transactions also protect minority shareholders from abuse and foster investor confidence.

26. Marketplaces include stock exchanges, dealer markets, organized over-the-counter markets and, most recently, alternative trading systems. In addition to operation of a marketplace, these organizations may function as SROs, or may also operate clearing and settlement systems. The Principles require licensing and oversight of marketplaces and require that regulators ensure management of large exposures, default risk and market disruptions, aimed at ensuring the smooth functioning of the markets. The Principles suggest markets should be transparent but no standard of transparency has been established; markets of course have varying degrees of transparency. In addition, the Principles require that regulations address unfair trading practices, such as market manipulation and insider trading. The Principles also state that clearing and settlement systems should be subject to an appropriate level of oversight that will ensure the systems operate effectively and efficiency and that the systems reduce systemic risk. More detailed

standards for the operation of clearing and settlement systems are contained in the CPSS/IOSCO Recommendations for Securities Settlement Systems.⁴

27. **Regulation of derivatives markets is aimed at preventing market disruption due to the failure of one party to a contract to meet its obligations—regulation therefore focuses on margin requirements, large exposures and clearing and settlement.** Securities regulators generally have jurisdiction over organized derivatives markets (where margin rules are enforced) and market intermediaries vis-à-vis capital requirements for derivatives held in inventory or margin lending to clients investing in derivatives. The Principles require the regulator to address large exposures and clearing and settlement issues with a view to the derivatives markets. Securities regulators do not usually have jurisdiction over over-the-counter derivatives trading—particularly that between large financial institutions—which constitutes the overwhelming bulk of the value of derivatives trading.

28. **Investment funds are subject to regulation as institutions through licensing requirements, internal control and management standards and legal structure, and as issuers through disclosure requirements.** The Principles require that funds be subject to licensing standards and that operators be vetted by the regulator and that regulations prescribe the legal form and structure of funds and the segregation of client assets so that investors' ownership interests are separate and protected. In accordance with the Principles, investment funds should also be subject to disclosure requirements, including audited financial statements, and that the method of calculated net asset value of the fund be clearly defined and disclosed and that such calculation be monitored by the regulator.

29. **Securities regulators face many current challenges common to the financial sector—the growth of cross-border business and cross-border markets and the implications for investor protection and enforcement, increased complexity of financial products and financing strategies and the consolidation of financial services globally, to name a few.** Globalization of financial services has drawn securities regulators into increased cooperation with each other in the form of joint policy work through IOSCO, bilateral work between jurisdictions and increased emphasis on information sharing between jurisdictions. Regulators continue to grapple with the effects of financial consolidation and work with counterparts in banking and insurance to work toward greater understanding of the exposures each sector has to the others as well as the operation of financial conglomerates. Securities regulators do not, for example, directly regulate hedge funds however, like their

⁴ Only a few of the FSAP assessments to-date have included a full assessment of the CPSS/IOSCO Recommendations. The Financial Stability Forum has recognized the Recommendations as a key standard and it is contemplated that these standards will be assessed in more complex markets and it is expected that the Executive Boards will be asked to decide whether to recognize the Recommendations as a standard or code for the purposes of the ROSC.

banking and insurance counterparts, they have raised concerns about the potential systemic impact of such investment vehicles.

C. IOSCO and the Principles

30. **IOSCO is an association of 172 members (securities regulatory agencies, self-regulatory organizations and international institutions) representing approximately 100 jurisdictions.** The Bank and Fund are both affiliate members of IOSCO.

31. **The Principles, endorsed by IOSCO at its Annual Meeting in 1998, establish the parameters of an effective system of securities regulation.** The Principles cover such areas as the regulator, enforcement, issuers, market intermediaries, collective investment schemes and secondary markets and, while not intended to be prescriptive, nevertheless establish standards against which effective supervisory arrangements and practices might be measured. IOSCO is currently undertaking a self-assessment exercise, in which each jurisdiction must assess its own performance against the Principles. The self-assessment exercise is intended to test general compliance of IOSCO members with the overall framework of the Principles, and, through detailed questionnaires, more specific adherence to individual sets of Principles.

32. **The IOSCO Principles were identified by the Financial Stability Forum (FSF) as one of the 12 key international standards and became part of the Report on the Observance of Standards and Codes (ROSC) and the FSAP during the pilot program in 1999.** The assessments of IOSCO Principles are carried out by Bank and Fund staff, and by experts suggested by IOSCO. It is understood that the experts do not represent IOSCO while engaged in the FSAP process. Summaries of these assessments, the ROSC, also form part of the IMF Financial System Stability Assessment report in the context of Article IV surveillance. The ROSC and detailed assessment can be made public at the discretion of the national authorities.

33. **The Bank and Fund work closely with IOSCO on the use of the Principles through the IOSCO Implementation Committee.** IOSCO has recently undertaken to develop an assessment methodology for the Principles, building on work begun by the Bank and Fund. Staff members of the Bank and Fund have also given joint presentations to the Technical, Executive and Emerging Markets Committees of IOSCO on the subject of financial sector assessments. In addition to direct work on the Principles, the Bank and Fund have consulted with IOSCO in relation to other areas of the FSAP, including the MFP Transparency Code and anti-money laundering initiatives

Box 1. IOSCO Objectives and Principles of Securities Regulation

Objectives

The three core objectives of securities regulation are:

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

Principles

Principles relating to the regulator

1. The responsibilities of the regulator should be clear and objectively stated.
2. The regulator should be operationally independent and accountable in the exercise of its functions and powers
3. The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.
4. The regulator should adopt clear and consistent regulatory processes.
5. The staff of the regulator should observe the highest professional standards, including appropriate standards of confidentiality.

Principles of self-regulation

6. The regulatory regime should make appropriate use of self-regulatory organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, to the extent appropriate to the size and complexity of the markets.
7. SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.

Principles for the enforcement of securities regulation

8. The regulator should have comprehensive inspection, investigation and surveillance powers.
9. The regulator should have comprehensive enforcement powers.
10. The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.

Principles for cooperation in regulation

11. The regulator should have authority to share both public and non-public information with domestic and foreign counterparts.
12. Regulators should institute information sharing mechanisms that establish when and how they will share both public and non-public information with their domestic and foreign counterparts.
13. The regulatory system should allow for assistance to be provided to foreign regulators who need to make enquiries in the discharge of their functions and exercise of their powers.

Principles for issuers

14. There should be full, timely and accurate disclosure of financial results and other information that is material to investors' decisions.
15. Holders of securities in a company should be treated in a fair and equitable manner.
16. Accounting and auditing standards should be of a high and internationally acceptable quality.

Principles for collective investment schemes

17. The regulatory system should set standards for the licensing and the regulation of those who wish to market or operate a collective investment scheme.
18. The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.
19. Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.
20. Regulation should ensure that there is a proper and disclosed basis for asset valuation and pricing and the redemption of units in a collective investment scheme.

Principles for market intermediaries

21. Regulation should provide for minimum entry standards for market intermediaries.
22. There should be initial and ongoing capital and other prudential requirements for market intermediaries.
23. Market intermediaries should be required to comply with standards for internal organization and operation conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters.
24. There should be procedures for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.

Principles for the secondary market

25. The establishment of trading systems, including securities exchanges, should be subject to regulatory authorization and oversight.
26. There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.
27. Regulation should promote transparency of trading.
28. Regulation should be designed to detect and deter manipulation and other unfair trading practices.
29. Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.
30. The system for clearing and settlement of securities transactions should be subject to regulatory oversight, and designed to ensure that it is fair, effective and efficient and that it reduces systemic risk.

III. PRINCIPLES ASSESSMENT PROCESS AND FINDINGS

A. Assessment Process

34. **In the context of the FSAP, the assessment of the regulation of securities markets seeks to strengthen oversight of this important sector of the financial system by identifying weaknesses in supervisory practices.** In carrying out assessments, reference is made primarily to the Principles, although assessors may also have regard to relevant legislation, regulations and policy pronouncements, as well as the self-assessments already undertaken by IOSCO members. Interviews are conducted with regulatory officials, professionals and market participants in the jurisdiction under review.

35. **The assessment of the Principles is conducted by staff of the Bank and Fund, and by experts nominated by IOSCO where appropriate.** Generally only one assessor is used although there is a recognition that for complex markets, two may be required. While experience demonstrates the utility of IOSCO experts in the assessments of the securities markets, resource constraints at IOSCO member agencies will necessarily limit the number of assessment missions for which IOSCO can provide expertise. There is scope, however, for IOSCO to make available experts to assist in the review process for completed assessments, in coordination with the Fund's panel of external reviewers.⁵

36. **As the legal and regulatory framework, and level of market development, varies significantly among jurisdictions, more guidance on calibration of assessments may be necessary to ensure consistency in, and comparability of, the findings.** This is particularly true in jurisdictions where there is the likelihood of significant developments in local market activities that might test the existing regulatory structure. The proposed guidance note for assessors will also provide assistance in this regard.

37. **External experts who have conducted assessments provided feedback on the assessment process—such consultations have identified, in particular, the preparation of assessors for missions and coordination of work in the field as requiring attention.** Many assessors expressed the desire for the entire team involved in the assessment to meet prior to the commencement of the mission, in order that expectations with respect to the conduct of the review were outlined, the context of the work (including local factors relevant to the assessment) could be clearly conveyed and cross-sectoral issues identified, early in the process. Ideally, pre-mission preparatory work would seek to outline prudential and macroeconomic conditions in the country to be assessed, and clarify expected outputs and scope of the task.

38. **The FSAP is a collaborative effort and the close cooperation between the assessor and staff of the regulator throughout the assessment is essential and ideally**

⁵ The IMF has established an external review panel as a means of supplementing staff resources devoted to the internal review process.

results in a consensus view. Authorities typically comment on draft findings during the mission and follow-up work ensures that the regulator is provided with the overall findings of the FSAP and is therefore able to view the various sectoral relationships in the context of the overall assessment of the financial system. Concurrently, findings are presented to other authorities and the responsible Minister, Governor or other government official. Increasingly, countries have chosen to publish the ROSC, including a summary of the IOSCO assessment, allowing other interested parties to become more familiar with these issues.

B. Preconditions Assessment

39. **The Principles describe a number of preconditions necessary for effective securities regulation.** These include, *inter alia*, sound and sustainable macroeconomic policies conducive to investment and savings, enforceable property rights, an effective legal, tax and accounting framework (including infrastructure for clearing and settlement systems and payments systems), as well as corporate governance and insolvency mechanisms. IOSCO has also identified characteristics of an effective regulatory regime consistent with sound economic policies:

- there should be no unnecessary barriers to entry and exit from markets and products;
- the markets should be open to the widest range of participants who meet the specified entry criteria;
- in the development of policy, regulatory bodies should consider the impact of the requirements imposed; and
- there should be an equal regulatory burden on all who make a financial commitment or promise.

40. **The assessment of preconditions has, in general, been cursory.** While many of the preconditions and attributes might readily be identified having regard to structural aspects of the regulatory regime, the assessment of the relative merits of such arrangements in the context of the size, complexity and level of sophistication of the jurisdiction being reviewed necessarily involves qualitative judgments as to their adequacy. Developing and emerging market FSAPs may have included a separate assessment of the legal framework undertaken by legal staff of the Bank. Such assessments have proven useful to the IOSCO assessor in assessing the pre-conditions of securities regulation. However, assessments would also benefit from further elaboration of the basis on which preconditions are to be evaluated, taking into account the various regulatory and policy mechanisms available.

41. **Establishing the preconditions necessary for an effective securities supervisory regime presents significant challenges for some jurisdictions with nascent market infrastructure.** There is a demand for greater skills and institutional support (such as legal, accounting and technology systems) in those jurisdictions—in some cases, authorities have

indicated that the lack of infrastructure has been an impediment to implementation of the Principles.

42. **Of the concerns identified in the assessment of preconditions, the most frequently cited relate to the inadequacy of general bankruptcy and insolvency procedures.** In particular, some assessments noted that no special insolvency or winding up provisions existed in the legislation of the countries reviewed, or there were gaps in existing legislation, for example in relation to segregation of client assets in the event of failure of a market intermediary.

43. **Some assessors observed that, while a comprehensive legal framework existed, there were concerns as to the enforceability of legal obligations through the court system.** This was particularly the case where lower courts were responsible for administering civil penalties, and in situations where the judiciary was less familiar with complex financial transactions. The ability of regulators to have a range of sanctions at their disposal, including in particular administrative action, was therefore seen as desirable.

C. Assessment of Principles

General observations

44. **The absence of an assessment methodology has contributed to inconsistencies in the outcomes of the assessment process as it relates to the Principles.** The general nature of the Principles, the ongoing development of the process of effectively implementing the Principles, and the varying degrees of market development evident in the jurisdictions surveyed, require that more comprehensive and consistent guidance be provided. Such guidance will supplement the experience of the assessors, ensuring depth, consistency and overall quality of the assessments.

45. **In formulating guidance, and in carrying out assessments, it should be recognized that implementation of the Principles may be achieved through a range of regulatory approaches.** The Principles were developed to provide a benchmark against which an effective securities regulatory regime might be measured. That there are different legal and regulatory systems among jurisdictions, often reflecting disparate market conditions, necessitates greater preparatory work to ensure that assessors are familiar with the overall domestic context of the jurisdiction being reviewed.

46. **The Principles, in providing a broad survey of the means by which effective regulation might be established, do not explicitly allow for relative weight to be assigned to particular areas of regulation.** Given the scope of the Principles, some assessors have observed that the time given to complete an assessment does not afford the opportunity to adequately test the jurisdiction against the standards. Moreover, the objectives of the FSAP, in seeking to identify material vulnerabilities in the securities supervisory framework, may warrant greater attention being paid to certain of the Principles, or groups of Principles. Further work might be undertaken by the Bank and Fund, in conjunction with IOSCO, to

better link the assessment of the Principles with financial stability and capacity-building needs.

47. While a core objective of a well-functioning securities regulatory regime is the reduction of systemic risk, the Principles were not designed with the FSAP in mind and an assessment based on them may therefore not capture all relevant vulnerability issues. In particular, the Principles are not currently geared to exposing short-term vulnerabilities, as might arise for example in the context of a delivery failure in the clearing and settlement system of a jurisdiction (although it should be noted that further work is contemplated in this area by IOSCO). The Principles also do not necessarily test in any comprehensive way issues such as corporate governance, although weaknesses in this or other areas may be relevant to the identification of sectoral vulnerabilities.

Main findings and assessment recommendations

48. The assessment is a dynamic process—the assessor seeks comment from the authorities and the general mission prior to finalizing both findings and recommendations and priority setting. Findings under each Principle are drafted in the form of assigned calibrations together with specific comments and followed by recommendations. The recommendations include steps necessary to fully implement a Principle or where the Principle has been fully implemented actions that could enhance regulations. Assessors also make recommendations that address necessary action should conditions in the country change—as in the case of many emerging market and transition economy countries.

Table 2. IOSCO Assessments: Percentage shares of observance⁶ with the IOSCO Objectives and Principles of Securities Regulation

Principle	Imp 1/	Part Imp 2/	Not Imp 3/	N/A 4/
1. The responsibilities of the regulator should be clear and objectively stated.	94.1		5.9	
2. The regulator should be operationally independent and accountable in the exercise of its functions and powers.	52.9	41.2	5.9	
3. The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.	58.8	35.3	5.9	
4. The regulator should adopt clear and consistent regulatory processes.	88.2	5.9	5.9	
5. The staff of the regulator should observe the highest professional standards, including appropriate standards of confidentiality.	76.5	17.6	5.9	
6. The regulatory regime should make appropriate use of self-regulatory organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, to the extent appropriate to the size and complexity of the markets.	70.6	23.5		5.9
7. SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.	64.7	29.4		5.9
8. The regulator should have comprehensive inspection, investigation and surveillance powers.	70.6	23.5	5.9	
9. The regulator should have comprehensive enforcement powers.	52.9	41.2	5.9	
10. The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.	47.1	35.3	17.6	
11. The regulator should have authority to share both public and non-public information with domestic and foreign counterparts.	70.6	23.5	5.9	
12. Regulators should institute information sharing mechanisms that establish when and how they will share both public and non-public information with their domestic and foreign counterparts.	64.8	23.5	11.7	
13. The regulatory system should allow for assistance to be provided to foreign regulators who need to make enquiries in the discharge of their functions and exercise of their powers.	58.8	41.2		
14. There should be full, timely and accurate disclosure of financial results and other information that is material to investors' decisions.	53.0	47.0		
15. Holders of securities in a company should be treated in a fair and equitable manner.	64.7	35.3		
16. Accounting and auditing standards should be of a high and internationally acceptable quality.	53.0	47.0		
17. The regulatory system should set standards for the licensing and the regulation of those who wish to market or operate a	70.6	11.8	17.6	

⁶ The calculations in this table are based on a survey of 22 completed FSAPs. Grading terminology varied between assessments. It has now been agreed that grading will reflect the suggested IOSCO model as indicated in the Table. The calculations in this table are based on a survey of 22 completed FSAPs.

Principle	Imp 1/	Part Imp 2/	Not Imp 3/	N/A 4/
collective investment scheme.				
18. The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.	70.6	17.6	11.8	
19. Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.	64.8	23.5	11.7	
20. Regulation should ensure that there is a proper and disclosed basis for asset valuation and pricing and the redemption of units in a collective investment scheme.	58.9	29.4	11.7	
21. Regulation should provide for minimum entry standards for market intermediaries.	88.2	5.9	5.9	
22. There should be initial and ongoing capital and other prudential requirements for market intermediaries.	53.0	47.0		
23. Market intermediaries should be required to comply with standards for internal organization and operation conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters.	58.8	29.4	11.7	
24. There should be procedures for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.	52.9	41.2	5.9	
25. The establishment of trading systems, including securities exchanges, should be subject to regulatory authorization and oversight.	88.2	5.9	5.9	
26. There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.	70.6	17.6	5.9	5.9
27. Regulation should promote transparency of trading.	70.6	17.6	5.9	5.9
28. Regulation should be designed to detect and deter manipulation and other unfair trading practices.	35.3	58.8		5.9
29. Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.	76.5	5.9	11.7	5.9
30. The system for clearing and settlement of securities transactions should be subject to regulatory oversight, and designed to ensure that it is fair, effective and efficient and that it reduces systemic risk.	58.8	35.3		5.9

1/ Implemented: includes assessment gradings "implemented", "fully compliant", "materially compliant", "observed", and "largely observed".

2/ Partially Implemented: includes assessment gradings "partially implemented", "partially compliant", and "partially observed".

3/ Not Implemented: includes assessment gradings "not implemented", "materially non-compliant", "non-compliant", "materially non-observed", and "non-observed".

4/ Not Applicable: no relevant market sector against which compliance could be assessed

Principles relating to the regulator, Principles 1–5

49. **While the assessments indicate that these Principles generally have been implemented, the adequacy of resources, scope of responsibility and independence of the regulator were identified as areas for strengthening in many jurisdictions:**

- **Adequacy of resources.** Many agencies, particularly in developing markets, were identified as having limited resources to discharge the full range of responsibilities assigned and also experienced difficulties in attracting and retaining skilled staff. The manner in which agencies are funded, in particular, is often relevant to the capacity of the regulator to effectively supervise the securities markets. With respect to financing, in some cases self-funding was seen as an appropriate model to provide the financial resources necessary to carry out regulatory responsibilities and attract and retain skilled staff.
- **Independence of the regulator.** The administrative control of the regulator's budget by the Ministry of Finance or other governmental body was viewed in some jurisdictions as having the potential to compromise operational independence. The manner in which the head of agency was appointed, and the nature of the appointment, were also seen as having the potential to lead to unnecessary political intervention in the operations of the regulator.
- **Scope of responsibility.** The spread of regulatory responsibilities across several agencies or the lack of clarity of roles, particularly between an SRO and regulator, have the potential to dilute the overall effectiveness of the regulatory regime. Where unclear demarcation of responsibility existed, the parties involved often resorted to more flexible and informal administrative arrangements to ensure appropriate oversight was maintained.

Principles of self-regulation, Principles 6–7

50. **There was widespread adherence to these Principles, although this may be due in part to the fairly accommodating wording of Principle 6 in particular and the lack of specific criteria under these Principles.** It should be noted that the governance structure and oversight arrangements for SROs differ markedly between jurisdictions, and the capacity of SROs to fulfill their regulatory responsibilities is often difficult to evaluate in the FSAP process. Importantly, the nature and extent of the SRO's regulatory function will inform the approach to oversight by the regulator.

51. **While many SROs perform a surveillance role, their ability to monitor market activity could be adversely affected by their limited electronic surveillance capability.** This, coupled with a lack of appropriate resources to analyze the available data, would be detrimental to the overall effectiveness of the surveillance process. Assessments encouraged the implementation of more systematic monitoring of trading on the exchanges.

52. **Although most SROs have in place a defined disciplinary procedure for their members, it is sometimes difficult to gauge their capacity to investigate and administer breaches of their rules.** The level of interaction with the regulator, particularly with respect to oversight of market conduct, clearly has a bearing on the effectiveness of the regulatory structure and, where market oversight was largely left to the SROs, recommendations were made for the regulator to conduct reviews and inspections of the exchanges.

Principles for the enforcement of securities regulation, Principles 8–10

53. **Comprehensive and effective enforcement powers vested in the regulator are essential to maintain the integrity of the securities markets. While most regulators have adequate powers of inspection, investigation and surveillance, concerns were identified in nearly every assessment with respect to the ability of regulators to enforce compliance with the law and administer appropriate penalties.** Although periodic (scheduled) and “for cause” inspections of regulated entities are generally undertaken, the level of inquiry differs greatly between jurisdictions. For some regulators, the lack of skilled staff resources also hampers their ability to effectively undertake surveillance of the markets. Moreover, the effectiveness of the oversight process is sometimes diminished where there are limited sanctions at the disposal of the regulator, or where there are issues concerning the enforceability of penalties through the legal system. Where administrative sanctions, which are essential to the regulator’s ability to both enforce the law and encourage compliance through deterrence, were not available to the regulator, strong recommendations were made for agencies to seek such powers.

Principles for cooperation in regulation, Principles 11–13

54. **Regulators sometimes do not have the ability to share information with other domestic regulatory bodies, or are hampered in this endeavor by administrative or legal hurdles.** This has obvious implications for the effectiveness of the regulatory regime, in particular in the timely identification of systemic risks. It also has consequences with respect to the conduct of cross-border investigations, in that information sought by a foreign counterpart relating to another sector of the financial system may not be readily available. It should also be noted that banking secrecy laws often prevent authorities from accessing information relevant to their investigation. Recommendations in this area therefore included the strengthening of cooperation between domestic supervisory authorities.

55. **Cross-border information sharing and cooperation between regulators is strongest in circumstances where a Memorandum of Understanding (MOU) or other formalized arrangement is in place.** Many regulators have negotiated such arrangements with their foreign counterparts, usually in accordance with the ten principles established by IOSCO some years ago.⁷ Where MOUs do not exist, many regulators adopt informal means

⁷ *Principles of Memoranda of Understanding*, Report of the IOSCO Technical Committee, September 1991.

by which publicly available information might be shared. In some jurisdictions, there remain legal impediments to regulators sharing information with foreign agencies, often in the form of constitutional protections, freedom of information requirements or privacy legislation. The assessments found that regulations and procedures often needed to be enhanced in order to fully implement MOUs.

Principles for issuers, Principles 14–16

56. **The assessments indicate that most jurisdictions surveyed have further progress to make in fully implementing this set of Principles.** In particular, it was not clear to some assessors that regulators had adequate powers—and the administrative capability—to prevent the issue of a prospectus into the market if minimum content requirements were not met, or that the regime facilitated public access to issue and other disclosure documents lodged with the regulator and/or exchange.

57. **While many jurisdictions had the basic elements necessary for an effective disclosure regime, such as requirements for point of sale and periodic information to investors, there were often shortcomings identified in continuous disclosure regimes with respect to the content and timeliness of reporting obligations.** The effectiveness of disclosure of information on matters or events that would be expected to have a material effect on the price or value of securities traded on an exchange could be compromised by delays in reporting of these triggering events. Recommendations thus focused on the need for such information to be disclosed as soon as practical to all market participants.

58. **In particular, many jurisdictions could strengthen provisions relevant to the protection of minority shareholders' interests.** For example, the disclosure of share ownership levels that exceed specified thresholds (often 10 percent of the issued capital of a company) has generally been required, as has reporting of related party transactions—however, quite generous reporting timeframes are evident in some countries. Timely access to information of this nature goes to the confidence of investors in the integrity of the market. Recommendations were thus made to tighten the period in which such disclosure might be made to market participants.

59. **The role of auditors is key to ensuring appropriate financial reporting and corporate disclosure—auditing issues are pervasive throughout the financial sector.** The oversight of the profession could be enhanced in many jurisdictions by greater involvement of external bodies in the disciplinary processes for accountants and auditors. While the development and adoption of internationally acceptable accounting standards is ongoing in most jurisdictions, recent corporate events in major markets have highlighted the need for stronger supervision of the activities of accountants and auditors, to ensure widespread compliance by audited entities with existing accounting standards. There is no one model suggested for improved oversight of the profession—although not the sole responsibility of the regulator, some form of independent review of the activities of accountants and auditors was, however, seen as desirable.

Principles for collective investment schemes, Principles 17–20

60. **Those jurisdictions with mature and deep securities markets exhibited a strong legal framework for the regulation of collective investments. While specific governance requirements for collective investment schemes vary between jurisdictions, regimes were generally comprehensive in their provision for distribution, disclosure, management and custody of mutual fund assets.** However, some assessors concluded that the resources available to regulators may not be sufficient to ensure adequate supervision of fund distributors over the life of a scheme. This was particularly the case where an active SRO had yet to be established. In jurisdictions with less-developed markets for collective investments, assessors noted the need for clarification of the definition of related parties (principal/agent) and recommended that regulators ensure appropriate custodial arrangements—relating to the independence (though not necessarily non-affiliation) of the custodian and segregation of assets in particular—were in place.

Principles for market intermediaries, Principles 21–24

61. **The licensing process, designating minimum entry standards for market intermediaries, was assessed as adequate in most jurisdictions. However, other aspects of the regulation of intermediaries, such as risk management and internal organization of firms, capital adequacy and other prudential controls, and procedures in the event of the failure of an intermediary, require strengthening.** Regulatory shortcomings in these areas may have particular consequences with respect to public confidence in the securities markets and, in the case of inadequate mechanisms to address the failure of a firm, potential systemic risks. It should be noted that concerns may also need to be addressed in the context of wider legislative reform, for example in improvements to general bankruptcy procedures.

62. **Although the application of the licensing regime was generally viewed as satisfactory, assessments often concluded that more work was needed in relation to the extent to which prudential and business compliance was actively enforced.** For example, more frequent and targeted inspections were recommended for many jurisdictions. In some cases, the ability of the regulator to impose administrative sanctions—such as de-licensing an intermediary—was often limited, or the power for such action was vested in another domestic authority, and remedial steps were thus strongly recommended. Several assessments noted that, while initial capital rules were observed, the monitoring and/or reporting of ongoing capital requirements was not systematically enforced.

63. **The absence of an investor protection (guarantee) fund, to mitigate losses and ensure the orderly winding up of an intermediary in the event of a failure, was a concern to assessors in some jurisdictions.** Where guarantee funds were in place, the form and adequacy of existing compensatory arrangements—of particular relevance to restoration of public confidence in the markets and the reduction of systemic risk—were seen as necessitating review. In many countries, guarantee funds were in an embryonic stage and/or had not been tested by actual insolvencies. Concerns with respect to the absence of or

weakness in such protection schemes were particularly emphasized where general insolvency procedures were also inadequate.

Principles for the secondary market, Principles 25–30

64. **While the regulation of organized and off-exchange markets was generally seen as satisfactory, there was a strong sense that the detection and prosecution of manipulation and other unfair trading practices was inconsistently enforced.** Often, identification of illicit trading activities was potentially compromised by the limited integration of the surveillance function between the exchange and the regulator. Poor communication in this regard could also limit the regime’s ability to properly manage market disruption and assessors recommended that, in some jurisdictions, procedures for the exchange of information be more clearly specified. Moreover staff resources to undertake monitoring of trading were often limited, even where there was an electronic surveillance capability and relatively clear lines of communication between the different arms of regulation. Recommendations were thus made to enhance the level of skilled surveillance staff in some jurisdictions.

65. **Most jurisdictions enforce transparency of trading in their respective markets.** In some cases, transparency could be enhanced through better and more timely provision of pre-trade information and recommendations were made to this effect. In more developed markets, the release of price-sensitive information through the exchange’s electronic facility was usually observed as efficient, although steps could be taken in some jurisdictions to ensure that investors have the same level of access to information as that of direct market participants.

66. **There were weaknesses identified in the oversight of clearing and settlement systems in some assessments.** For example, the ability of regulators to properly monitor the adequacy of margin requirements was sometimes limited, or there were gaps in the regulation of short selling which had the potential to lead to delivery failures and, ultimately, systemic risk through the unwinding of settlements for a number of counterparties. Although the assessments touched on potential sources of vulnerability in this area, many assessors felt that such a discussion might best be taken up in a separate assessment under the CPSS/IOSCO recommendations.

Emerging market country and developed country comparisons

67. **Assessment calibrations are not easily compared between countries and do not lend themselves to broad conclusions regarding the quality of securities regulation in developed countries versus emerging market countries.** Ratings, using the IOSCO scale of implementation, were broadly consistent across countries with similar markets but calibration could be similar in developed countries and in emerging market countries as the context and complexity of markets appears to dictate the level of implementation. It would, therefore, be a mistake to focus on the country’s “report card” out of context—instead, the

assessment should be viewed as establishing a national benchmark and as an important input into the overall understanding of the financial sector.

Principles assessment and IOSCO self-assessments

68. **The FSAP has coincided with IOSCO's own efforts to assess implementation of the Principles through self-assessment questionnaires—these questionnaires have been a useful starting point in the FSAP process.** In most cases the IOSCO general questionnaire was used, however, more detailed self-assessments still under development at IOSCO have also been used as information-gathering tools. The completed self-assessments are available to IOSCO members through the member website, allowing for peer comparisons and further peer education.

69. **The self-assessments provided essential background information for the assessor and served as a focal point for the authorities' preparation for the mission.** The assessors considered the self-assessment questionnaires as background information, enabling the assessors to gain a basic understanding of the regulatory structure and key institutions and legal framework and providing them with a basis for further information requests. The authorities found the self-assessment process educative—completing the questionnaires mobilized staff of the securities regulators to become more familiar with the Principles, thus further enhancing their skill levels.

Implications for financial sector soundness and development

70. **The Principles assessments are providing important input to the assessment of overall stability and development needs in the financial system.** Development needs identified in the assessments related to strengthening legal frameworks and institutions—the need for stronger creditor protections in law, for example. In some cases, developing countries did not have the regulatory framework to address the introduction of mutual funds and this was cited as a developmental issue. However, in most cases weaknesses in securities market supervision have not been cited as contributing to overall financial system vulnerabilities.

71. **Potential vulnerabilities emanating from poor oversight of clearing and settlement systems, and weaknesses in implementation of regulatory standards through inspections and investigations, could be inferred from many of the assessment commentaries.** A more thorough understanding of the connections between supervision of securities markets and vulnerabilities and further work to enhance the contributions of the Principles' assessor will better enable the FSAP mission to test these connections.

72. **The IOSCO Principles may be an incomplete tool for investigation of weaknesses in supervision and regulation of securities markets or for connecting those weaknesses to macroeconomic vulnerabilities.** First, the Principles have been designed as broad aspirational statements rather than precise standards and reflect IOSCO's traditional focus on investor protection rather than systemic stability—this presents a challenge in using the Principles as a tool for assessing vulnerabilities. Second, many key issues are not dealt with

by the Principles; thus, full compliance with the Principles is not necessarily an indication that there are no vulnerabilities present. Some of issues that may have implications for systemic stability that are not fully considered by the Principles include detailed corporate governance standards, accounting and auditing requirements, bond market supervision, issues over-the-counter derivatives market supervision and cross-border activity. Consideration of these limitation will be the source of on-going work at the Bank and Fund and of dialogue with IOSCO.

IV. FOLLOW-UP FROM ASSESSMENTS

A. Authorities Response

73. **Country authorities have responded positively to the assessments, stressing their usefulness in providing practical insight to implementation of the Principles and in highlighting securities markets issues in the overall financial sector context.** The authorities regarded the process of being assessed as educative and viewed the assessor as a valuable resource. This was particularly true for countries in the midst of reform of the securities or financial sector supervisory framework—the assessment was able to assist in prioritizing and shaping those reforms. Securities regulators believe the assessment, as part of the FSAP, was a valuable opportunity to raise concerns with central government authorities and with industry.

74. **Each assessed country reported taking positive action to follow-up on recommendations made by the assessor—however, it was noted that legislative changes were more easily made than those that required additional resources or funding.** Many of the countries had responded to the assessment with proposed changes to the legislative framework; to acquire the necessary enforcement authority, for example. However, a number of countries reported difficulties in implementing recommendations that required recruitment of skilled staff, since in many regions skill shortages are acute and salaries remain uncompetitive. Recommendations that required increased funding, such as expansion of inspection programs or enhancement of surveillance technology, were also viewed as being less easily implemented. In some cases, these issues have been raised in the context of requests for technical assistance.

B. Technical Assistance

75. **Technical assistance in the area of securities markets regulation has been somewhat limited; however, growing interest in this area as an outcome of FSAP assessments may act to broaden our involvement.** As an example, a Bank technical assistance mission, which included Fund staff, visited India in June 2001 as follow-up to the FSAP mission in 2000. The mission produced a comprehensive draft report addressing a range of issues, including supervision of investment firms, effectiveness of the central regulator, structure and use of self-regulatory organizations, supervision of exchanges and issuer disclosure. It is contemplated that more requests for such assistance will be forthcoming and it is desirable that additional capacity in this regard be promoted.

76. **In addition to developing a capacity for follow-up technical assistance at the Bank and Fund, other multilateral initiatives are underway to provide support in this area.** The Financial Sector Reform and Strengthening Initiative (FIRST) is envisioned to be a joint program between the Department of International Development of the U.K. (DFID), the Canadian International Development Agency (CIDA), the State Secretariat for Economic Affairs of Switzerland (SECO), the Swedish International Development Agency (SIDA), the Norwegian Agency for Development (NORAD), as well as the Bank and the Fund, for the purpose of promoting robust and diverse financial systems in low and middle income countries. The purpose of FIRST would be to provide grants to low and middle income countries for technical assistance aimed at addressing financial system weaknesses and enhancing development opportunities in such countries. In addition, FIRST would provide resources for the establishment and operation of an information exchange on the delivery of financial sector technical assistance in low and middle income countries. The technical assistance and information exchange would include securities markets assistance and information where appropriate.

V. ENHANCING THE ASSESSMENTS

Improving Principles and assessment methodology

77. **The quality of assessments would be enhanced by a comprehensive assessment methodology, giving assessors criteria and additional guidance under each Principle.** The Principles document contains some detailed guidance as to the meaning of each Principle, however does not necessarily elaborate on what constitutes full implementation. It is desirable that criteria be developed to facilitate weighting of factors to be considered in assigning grades. The assessors have often been limited by a lack of direction as to how to treat the contextual setting—for example, the assessor is not provided with assessment findings for similar markets. This lack of direction has led to inconsistencies in the findings and lack of comparability of the assessment outcomes.

78. **A guidance note for assessors has been developed by Bank and Fund staff after consultation with IOSCO—the note will be available to assessors in April 2002.** The guidance note sets out criteria for assessment of the preconditions of securities regulation and the individual principles and standards for the calibration of the Principles. A key challenge for assessors is gauging whether the assessment criteria are fulfilled in practice, and not just in form. The guidance note seeks to address these concerns for the assessor.

79. **The process of developing a guidance note in cooperation with IOSCO will contribute to a clearer enunciation of the purpose underlying the stated Principles.** Given the changing nature of securities markets, the Principles require review to ensure their continuing appropriateness to maintaining the integrity and efficiency of securities markets. It is anticipated that the outcomes of the FSAP process will contribute to the on-going relevance and utility of the Principles. The assessment methodology to be developed by IOSCO may replace the staff guidance note. Continuing feedback from assessors in the field will be helpful in the development of this methodology.

Improving the process

80. **A number of improvements to the process that would address assessors' concerns are under consideration.** A terms of reference document setting out the mission's scope and expected outcomes will be provided to assessors prior to the mission. A similar document explaining the scope and role of the Principles assessments to mission chiefs will also be developed. Other means of strengthening pre-mission preparatory work are being considered—for example, ways in which background information can be effectively gathered.

81. **Improving communication between sector experts is an on-site challenge for the mission and requires greater interaction between mission members.** The terms of reference described above will alert mission chiefs and assessors to these issues. The guidance note will also improve awareness of cross-sectoral issues. As the Bank and Fund develop a better understanding of these cross-sectoral issues through the FSAP process and other initiatives underway, it is anticipated that this will be translated into more practical guidance for assessors.

Securities markets and vulnerabilities

82. **The main area of challenge for the Bank and Fund is to link the assessments to an identification of vulnerabilities in the financial sector.** Staff intend to make work in this area a priority. A deeper understanding of such linkages will increase the quality and usefulness of the assessments and the main FSAP reports. Greater understanding of vulnerability issues will enable the Bank and Fund to target resources, promote capacity building in this area and establish meaningful technical assistance programs in the securities markets area. Our insights in this area should also assist IOSCO in their consideration of the application of the Principles.

VI. CONCLUSION

83. **The assessment of the Principles has formed an important component of the FSAP, contributing to a better understanding of the relevance of securities market supervision to the overall stability and development of the financial system.** The Bank and Fund have identified areas for improvement that warrant prompt attention—the means of addressing these areas are currently under consideration and will most likely involve a coordinated effort on the part of the FSAP constituency. There have been many positive outcomes of the process; most importantly, the FSAP now clearly underpins Bank and Fund bilateral surveillance efforts in the securities sector, as well as our on-going relationship with IOSCO. The program also provides a platform from which other initiatives in the context of financial stability and development might be launched.