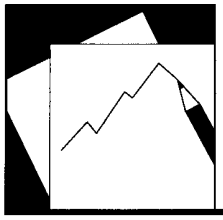
WP/07/259



IMF Working Paper

Strengths and Weaknesses in Securities Market Regulation: A Global Analysis

Ana Carvajal and Jennifer Elliott

INTERNATIONAL MONETARY FUND

 WP/07/259

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Monetary and Capital Markets

Strengths and Weaknesses in Securities Market Regulation: A Global Analysis

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November 2007

Abstract

This paper examines the strengths and weaknesses of securities regulatory systems worldwide with a view to a better understanding of common problems and areas of global concern. We found that a consistent theme emerges regarding the lack of ability of regulators to effectively enforce compliance with existing rules and regulation. In many countries, a combination of factors, including insufficient legal authority, a lack of resources, political will and skills, has undermined the regulator's capacity to effectively execute regulation. This weakness is more acute in areas of increased technical complexity such as standards for and supervision of the valuation of assets and risk management practices.

JEL Classification Numbers: K22, G18, G24, G28

Keywords: Securities markets; securities markets regulation;

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[1] This paper is based on an internal staff note on IOSCO assessment results prepared jointly with Claire Grose and Felice Friedman, both from the Finance and Private Sector Development Unit of the World Bank. We are very grateful to Claire and Felice for their contribution to the work and their additional comments on this paper. The paper benefited from the excellent research assistance of Ivan Guerra and Claudia Jadrijevic, to whom we also extend our thanks. We also thank the IOSCO Implementation Task Force for their helpful comments. We take full responsibility for all errors and omissions contained in this paper.

Contents Page

I. INTRODUCTION

1. Securities markets play a crucial role in economic growth and financial stability. The primary purpose of securities markets is to serve as a mechanism for the transformation of savings into financing for the real sector, thus constituting an alternative to bank financing. Markets provide the best (albeit sometimes imperfect) mechanism for asset pricing. Markets are also a mechanism through which risk is transferred and risk exposure diversified—which allows firms to unlock capital for new investments.[2] Risk transfer and pricing mechanisms in the market allow financial institutions, such as banks and insurance companies, to manage risk more efficiently; and markets may therefore work as a buffer for disruption of banking system and therefore contribute to financial stability. The more efficient markets are, the better these outcomes are achieved and the greater the contribution to the economy.

2. While the role of securities markets is more meaningful in developed economies, there is evidence of the growing importance of securities markets in emerging market and developing countries. In many emerging market and developing countries, securities markets are beginning to gain a place as a source of financing for the corporate sector, although in most markets this is initially restricted to the larger corporate players.[3] Along with private and public pension funds, collective investment schemes have become important players in many developing and emerging market countries and their demand for suitable investments is driving development.

3. Despite the growing understanding of the role that securities markets play, we find that the systemic importance of securities regulation has been neglected as a topic of academic study. It has been argued, most famously, in remarks by the former Chairman of

[2] Richard Herring and Anthony Santomero, 2000, "What is Optimal Regulation?" (Pennsylvania: Financial Institution Center, University of Pennsylvania).

[3] See, for example, Charles Amo Yartey, 2006, "The Stock Market and the Financing of Corporate Growth in Africa: the Case of Ghana" IMF Working Paper No. 06/201 (Washington: International Monetary Fund), which following on earlier work by Ajit Singh and J. Hamid, 1992, "Corporate Financial structures in Developing Countries" IFC Technical Paper, No.1 (Washington: International Finance Corporation) uses empirical evidence to show that the stock market is the most important source of long-term finance for listed companies in Ghana. There is also an emerging body of work linking economic growth with sound corporate governance (a central part of securities regulation) and minority shareholder protections see Raphael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishy 1999 "Investor Protection: Origins, Consequences and Reform" Financial Sector Discussion Paper No. 1, (Washington: World Bank), Stijn Claessens, 2005, "Corporate Governance and Development" World Bank Working Paper (Washington: World Bank).

the Federal Reserve Board, Alan Greenspan, that a financial sector that is well-rounded and does not rely entirely on the banking sector is less vulnerable to external shocks. Yet there have been few attempts to examine the effects of securities regulation, or regulatory weaknesses, on stability and growth.[4]

4. This paper examines the strengths and weaknesses of securities regulatory systems worldwide with a view to a better understanding of common problems and areas of global concern.[5] In doing so, we contribute to the depth of understanding of the state of regulation of securities markets around the world and enable others to further explore the connections between securities regulation and systemic risk and securities regulation and market development.

5. Our research suggests that securities regulatory systems suffer from persistent weaknesses in a number of countries and there is an urgent need for improvement. We have used the unique set of data produced under the IMF and World Bank Financial Sector Assessment Program (FSAP)—which entails a systematic assessments of regulatory systems—to examine problem areas and explore the connection to income level of the country and possible regional trends. We found that a consistent theme emerges regarding the lack of ability of regulators in many countries to effectively enforce compliance with existing rules and regulation. A combination of factors, including the lack of power and authority, a lack of resources and skill, and the lack of political will has undermined the regulator's ability to effectively execute regulation. This is a particular problem in areas of increased complexity—such as valuation of assets and risk management practices and internal controls requirements for market participants and trading systems.

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[4] One exception is Rafael LaPorta, Florencio Lopez-de-Silanes and Andrei Shleifer, 2003, "What Works in Securities Law" Journal of Finance, American Finance Association, vol.61(1(pages 1–32, 02. The paper concluded that there is a connection between stock market growth and strong legislation that allows effective recourse to private enforcement (tort law), but that there was no connection between growth and the presence of a strong regulator in the market. We find the paper's conclusions limited—there is little discussion of the connection between strong legislation and the regulator. It seems unlikely to us that jurisdictions in which legal protections for investors are high would not also have an effective regulator.

[5] Effective securities regulation relies on the existence of a sound framework, including good contract and corporate law, a fair and timely judicial process, effective protection of property rights, good accounting and audit standards and sound taxation rules.[5] We have observed that the lack of this basic framework has significantly affected the countries efforts to develop their markets and our observations are shared by others engaged in capital markets development work. We do not analyze these elements of a regulatory system, referred to as 'preconditions' in the paper, but do make mention of them where there is a direct and noted impact on the area of regulation. Annex 3 of the IOSCO Principles of Securities Objectives and Regulation sets out a list of matters to be addressed in domestic legislation.

II. WHAT IS SECURITIES REGULATION?

6. Securities regulation comprises the regulation of public issuers of securities, secondary markets, asset management products and market intermediaries. Regulation is designed to address asymmetries of information between issuers and investors, clients and financial intermediaries and between counterparties to transactions; and to ensure smooth functioning of trading and clearing and settlement mechanisms that will prevent market disruption and foster investor confidence.[6]

7. Regulation of public issuers is based on the principle of full, timely and accurate disclosure of relevant information to investors. Generally, securities regulators have moved away from merit-based regimes to disclosure-based regimes; that is, the regulator does not take on the role of determining whether or not an offer is too risky for investors—that is a decision to be made by the investor. Rather, the regulator's role is to ensure that investors are given full, timely and accurate information to enable them to make informed decisions. For that purpose disclosure obligations are imposed on issuers both at the moment of authorization for public offering and on a continuous basis. Mechanisms are also put in place to ensure the reliability of the information provided by issuers. More recently, the regulation of issuers has highlighted the need for adequate corporate governance to ensure effective accountability of management and board members to shareholders.

8. Regulation of market intermediaries seeks to ensure that intermediaries (such as brokers, dealers and advisers) enter and exit the market without disruption, conduct their business with their clients with due care and trade fairly in the markets. The main tools for the regulation of intermediaries are licensing requirements (including prudential requirements) and market and business conduct obligations.

9. The regulation of asset management aims to ensure professional management and adequate disclosure of investments to the investors. Most regulatory systems focus on collective investment schemes, usually in the form of mutual funds or unit trust funds. Because units of collective investment schemes are investment instruments, they are bound by the same principle of full, timely, and accurate disclosure applicable to issuers generally. In addition, the operator and investment manager of the collectives investment scheme are financial intermediaries and are regulated in a manner similar to other intermediaries.

10. The regulation of secondary markets seeks to ensure the smooth functioning of the markets. Regulation of market conduct and trading seeks to ensure fair access and adequate price formation, thus preserving the market's efficiency and reputation. Regulation also aims

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[6] A good overview of the approach to securities regulation can be found in Bernard Black, 2001 "The Legal and Institutional Preconditions for Strong Securities Markets," *UCLA Law Review*, vol. 48, (Los Angeles, California: University of California at Los Angeles), pp. 781–855.

to limit the disruptive effects that the failure of an intermediary could have on the market and, thus, is focused on ensuring that market participants settle their trading obligations in an orderly and timely manner through regulation of the clearing and settlement, and the setting of standards for risk management.

11. Responsibility for the development of the regulatory framework as well as the supervision of regulated entities is typically assigned to a public agency. The structure of the securities markets regulator may vary from a single-agency specialized in securities regulation to a unified regulator that regulates more than one sector. The regulatory framework should ensure that the regulator has sufficient independence, powers and resources to effectively regulate and supervise market participants. In most jurisdictions, self-regulatory organizations (SROs), such as exchanges, and industry associations, carry out part of the regulatory function in the jurisdiction (in many cases, SROs take on a significant role). In these cases, the regulatory framework should ensure proper oversight of SROs by the public regulator.

III. DATA

12. The IOSCO Objectives and Principles of Securities Regulation constitute a valuable tool to evaluate the strengths and weaknesses of a regulatory framework. The principles cover all the regulatory issues mentioned above, which are divided into eight different categories:

- Principles 1–5 concern the structure and effectiveness of the regulator,
- Principles 6 and 7 consider the role and structure of self regulatory organizations,
- Principles 8–10 examine the enforcement program and activities of the regulator,
- Principles 11–13 examine the regulator's cooperation with domestic and international counterparts,
- Principles 14–16 concern the regulatory regime for issuers,
- Principles 17–20 concern the regulatory regime for collective investment schemes,
- Principles 21–24 concern the regulation of market intermediaries, and
- Principles 25–30 consider the regulation of the secondary markets.

13. The principles were originally published in 1998 and a methodology to assess their implementation was approved in 2003.

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.

14. We examined the IOSCO principles assessments for 74 countries, completed between 1999 and September 2007. [7] Through the FSAP and the Offshore Financial Center (OFC) program, the IMF and the World Bank carry out assessments of securities regulatory systems using the IOSCO Principles and the IOSCO Methodology.[8] In each assessment of the

[7] A list of the country assessments that we reviewed is provided in Appendix I. All of them are used in the statistics; except Canada because grades were not assigned to the assessment.

[8] International Organization of Securities Commissions, 1998 "Objectives and Principles of Securities Regulation" (Madrid: IOSCO).

principles, a grade of fully implemented, broadly implemented, partly implemented or not implemented is assigned.[9] These grades, along with the detailed description and commentary of the assessor, have been collated in a database at the IMF.

15. The use of the assessments as a primary dataset has inherent limitations. The principles themselves are an imprecise instrument of measurement—they are broadly worded and were not, initially, designed as a measurement tool. The IOSCO Methodology and the assessor's template add a degree of direction to the assessments but the assessments remain subjective and require significant exercise of judgment on the part of the individual assessor. Assessments are carried out by one person and there were a total of 46 different assessors used. As a consequence, the consistency and quality of the assessments is somewhat mixed,[10] and this affects the usefulness of the data. In addition, the assessments are a one-time measurement of the regulatory system and are therefore limited by time. In most cases there has only been one assessment of the country (the exception is Mexico, which was assessed in 2001 and again in 2006). Further, over time assessors have worked under varying conditions—some with formal guidance, including the Methodology, and some without.

16. Despite these limitations, we found a great deal of consistency in the aggregate data. Those assessments produced with the Methodology, for example, did not differ significantly from those produced before it was adopted. The data have been consistent with our own understanding based on field work and with that of our colleagues at the World Bank and other development agencies.

17. Finally, because most assessments remain confidential we have used the data on a no-name, aggregate basis and have not discussed particular characteristics of any one regulatory system.

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[9] The grade of "broadly implemented" was introduced by IOSCO in 2002; this complicates the use of data comparing grades. In some cases a "not applicable" notation was made for a principle that did not apply (for example, in a country with no collective investment schemes, Principles 17–20 would not apply). Note also that this paper does not examine the findings related to Principle 30. Since the adoption of the IOSCO Principles and their Methodology a separate standard was develop to asses the robustness of clearing and settlement infrastructure.

[10] The quality and consistency of assessments was examined in 2002. See 2002 "Experience with the Assessments of the IOSCO Objectives and Principles of Securities Regulation under the Financial Sector Assessment Program" IMF Board Paper (Washington, D.C.: IMF and World Bank) . There is very little difference in our findings in 2002 from the findings enumerated in this paper.

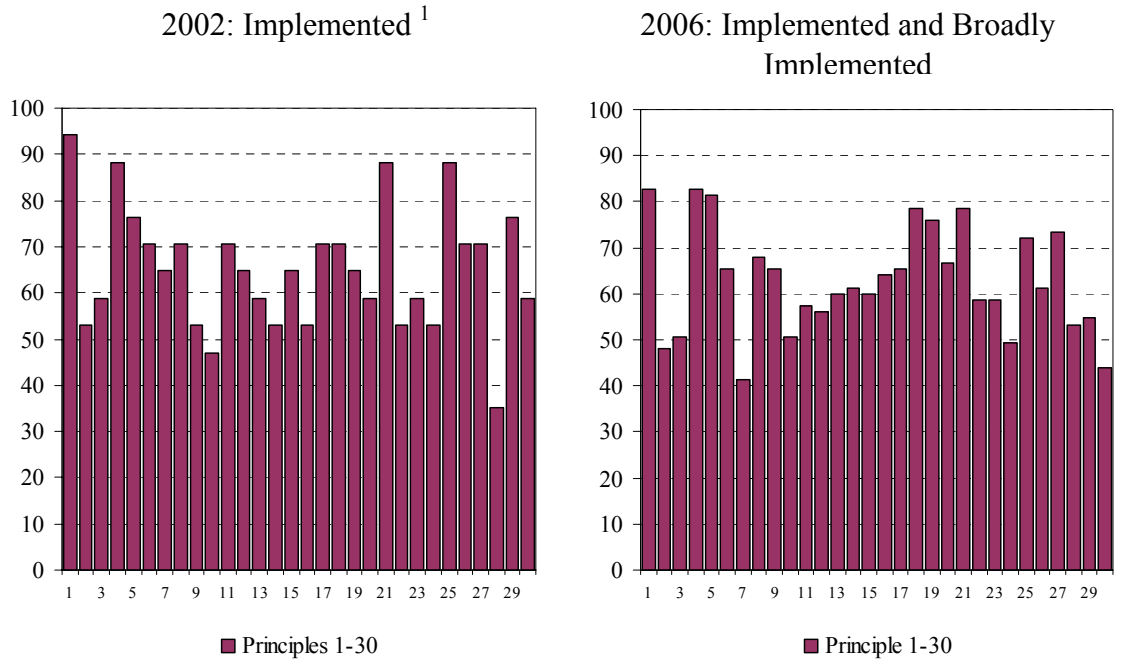
IV. General Findings

18. The assessments revealed significant weaknesses in many regulatory systems. In addition, although the intensity of the weaknesses might differ from one country to another, the findings of the assessors do show the existence of common themes. First, the lack of independence from the government and the political process appears to be the greatest challenge to the strength of the regulator, followed by a lack of legal authority and limited resources. Regulators frequently lack sufficient powers to license—and de-license—market operators and intermediaries and to conduct enforcement actions, and this lack of authority impedes their ability to operate an effective and credible enforcement program. Even when regulators have sufficient powers at their disposal, the conduct of enforcement in practice remains a challenge. These weaknesses are echoed in the specific topic areas—where resources and authority are limited, supervision is often weak. Areas that have become increasingly complex, such as the valuation of assets in collective investment schemes, or risk management practices in markets and investment firms, appear to need the most improvement.

19. These findings are captured by the statistics, which show that for the majority of the countries, full implementation of the IOSCO Principles still remains a challenge. As illustrated in the 2006 chart in Figure 1, only four principles (1, 4, 5, and 21) show levels of full implementation[11] equal or above 80 percent. Moreover, for four principles (2, 3, 10, and 24), the levels of implementation fall below 50 percent. Overall, the key findings on weaknesses mirror the key findings of the 2002 review of the first 22 countries, as illustrated below by a comparison of overall levels of implementation in 2002 and 2006.

[11] For the purpose of this section, the categories of Implemented and Broadly Implemented have been taken together.

Figure 1. Findings—2002 and 2006



Source: Standards and Codes Gateway (MCM) and staff estimates.

[1] The 2002 data reflect "Implemented" only. The broadly implemented grade was introduced later.

20. We also found a high correlation between the level of income of a jurisdiction and the level of implementation of the principles. Thus, as the income increases, so does the level of implementation**.** Low-income jurisdictions show levels of implementation below 50 percent, lower-middle income jurisdictions show levels of implementation around 50 percent, upper-middle income jurisdictions show levels of implementation around 60 percent, while high-income countries show levels of implementation above 70 percent.

21. The link to income is unsurprising, given the general findings elsewhere linking income to strength of institutions. We would also expect to find that wealthier countries have greater financial resources to dedicate to regulation, enabling the regulator to properly carry out the regulatory mandate. However, we note that the data does not allow us to directly link a lack of financial resources with other specific findings.[12]

[12] Principle 3, which measures adequacy of resources, also measures sufficiency of legal authority and capacity to perform regulatory functions. Assessments of this Principle do not provide uniform information on the level of financial resources and the impact this has on ability to function. A lack of resources at the regulator has been identified elsewhere, however, as a key challenge to developing market integrity. See Felice B. Friedman and Claire Grose and "Promoting Access to Primary Equity Markets: A Legal and Regulatory Approach", World Bank, Financial Sector Discussion Series, Washington DC, May 2006.

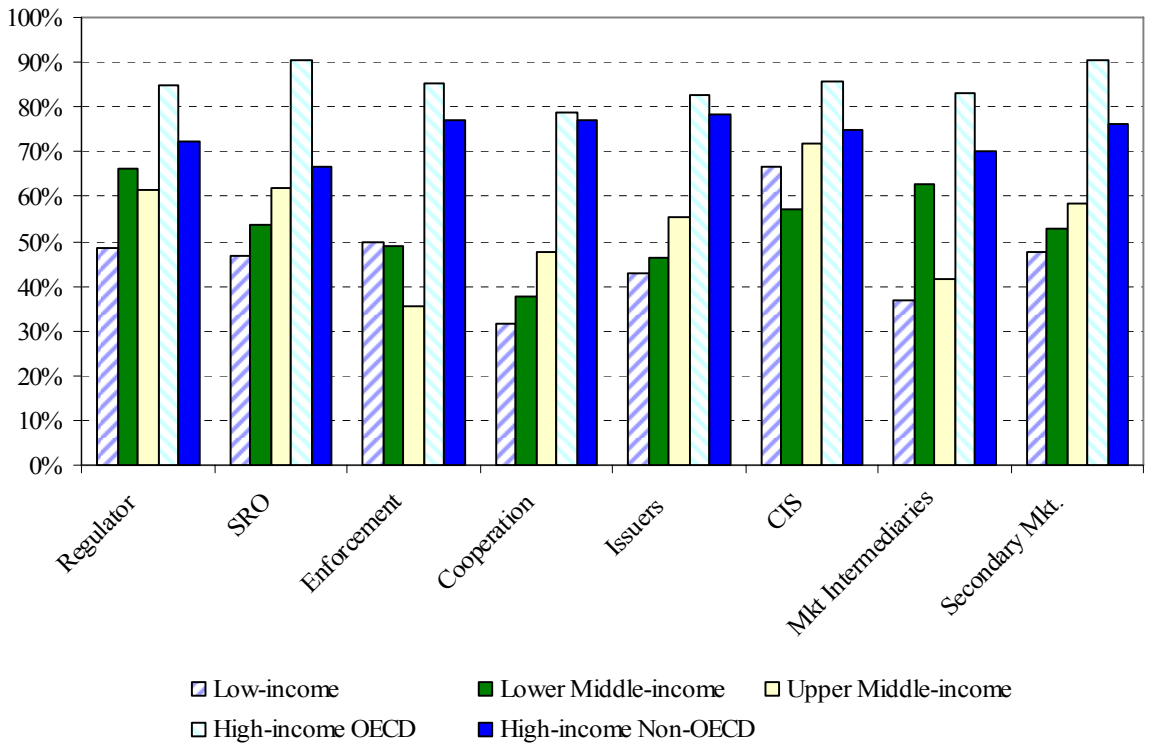
Table 1. IOSCO Categories and Countries Grouped by Income [1]

Category	Low-income	Lower Middle-income	Upper Middle-income	High-income OECD	High-income Non-OECD
Regulator	49	66	61	85	73
SRO	47	54	62	91	67
Enforcement	50	49	36	85	77
Cooperation	32	38	48	79	77
Issuers	43	47	56	83	79
CIS	67	57	72	86	75
Mkt Intermediaries	37	63	42	83	70
Secondary Mkt.	48	53	59	91	76

Source: Standards and Codes Gateway (MCM).

[1] Numbers in the table represent the average percentage share of the applicable and assessed principles for all countries grouped in the Fully and Broadly implementation levels.

Figure 2. IOSCO Categories and Countries Grouped by Income [1]



Source: Standards and Codes Gateway (MCM).

[1] Numbers in the table represent the average percentage share of the applicable and assessed principles for all countries grouped in the Fully and Broadly implementation levels.

22. Finally, regions show significant differences in the level of implementation, which, to a certain extent, are correlated with the overall income level of the region. Europe and Asia exhibit the highest levels of implementation, Western Hemisphere ranks in the middle, while the Middle East and Central Asia and Africa exhibit the lowest levels of implementation.

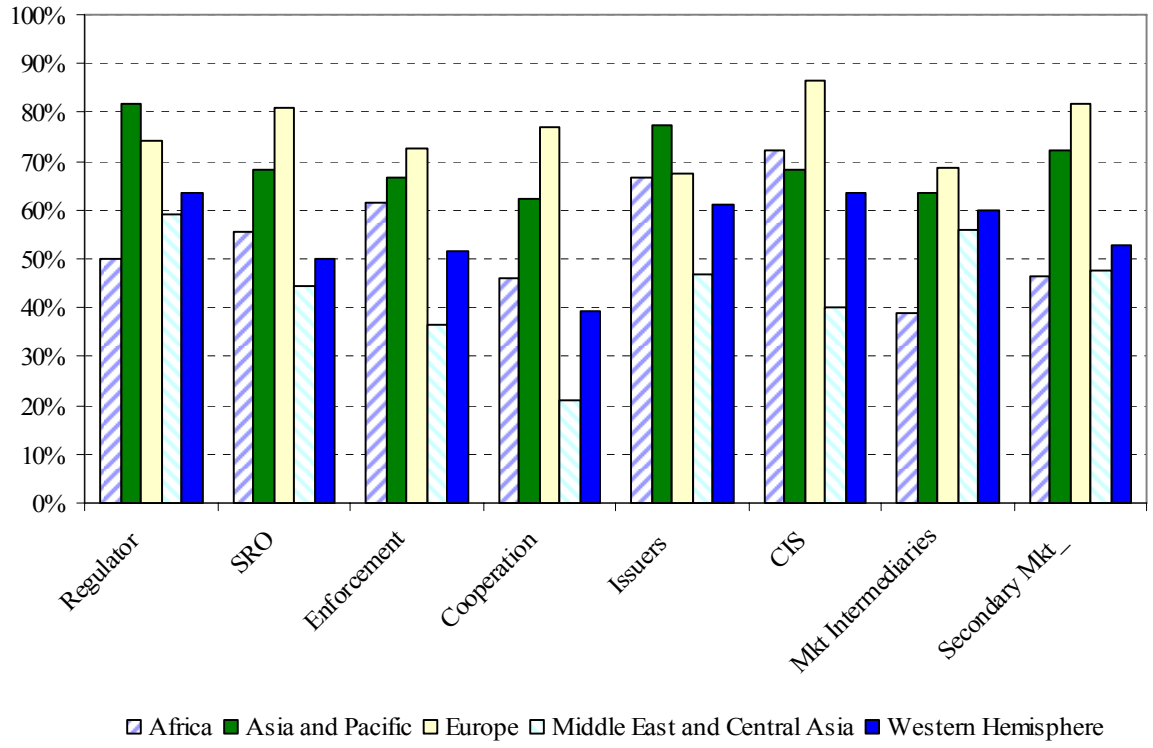
Table 2. IOSCO Categories and Countries Grouped by Region [1]

Region	Regulator	SRO	Enforcement	Cooperation	Issuers	CIS	Market Intermed.	Secondary Market
Africa	50	56	62	46	67	72	39	46
Asia and Pacific	82	68	67	63	77	68	64	72
Europe	74	81	72	77	68	86	69	82
Mid. East Central Asia	59	44	36	21	47	40	56	48
Western Hemisphere	64	50	52	39	61	64	60	53

Source: Standards and Codes Gateway (MCM).

[1] Numbers in the table represent the average percentage share of the applicable and assessed principles for all countries grouped in the Fully and Broadly Implemented levels.

Figure 3. IOSCO Categories and Countries Grouped by Region [1]



Source: Standards and Codes Gateway (MCM).

[1] Numbers in the table represent the average percentage share of the applicable and assessed principles for all countries grouped in the Fully.

V. SPECIFIC FINDINGS

A. Quality of the Regulatory Structure

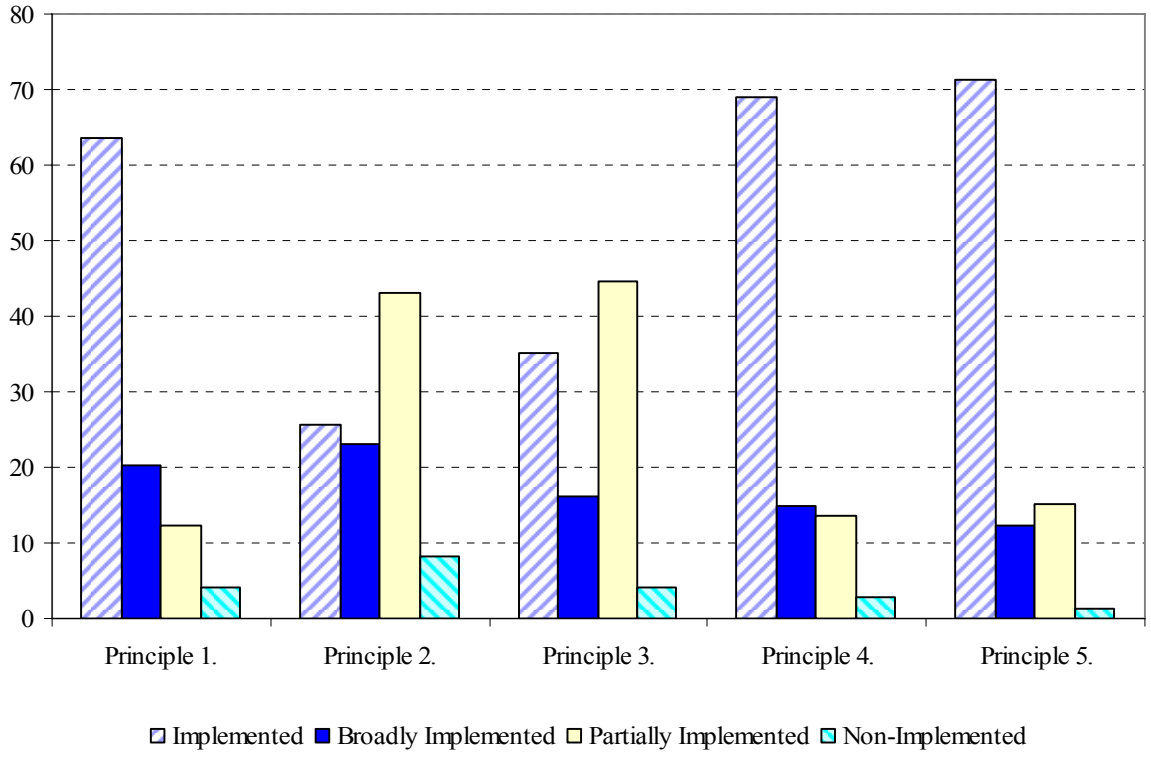
Statutory regulator

23. While in many countries securities markets started to develop without the existence of a public regulator, it is now widely accepted that the existence of a public entity charged with the regulation and supervision of the market and market participants, is key to the healthy development of markets. Regardless of the institutional structure chosen, it is important that the responsibilities of the regulator be clearly defined and that it be given an adequate level of independence, legal authority and resources to enable it to carry out its functions.

24. The assessments show that many regulators are not sufficiently independent of government and/or industry, with less than half of countries achieving a fully or broadly implemented grading. This may be because governance structures allow for interference in the regulator's daily activities, with the potential to cause regulatory forbearance, or because

funding or staffing mechanisms create avenues for outside control of the regulator actions. For example, some regulators cannot grant or withdraw licenses—a key supervision tool—instead that power remains with the Ministry of Finance. In other cases, the governing body of the regulator is controlled by a government ministry. While the trend has been toward fully independent regulators, there are still a significant number of agencies whose work is impeded by this political overshadowing which raises the potential for interference. Shortcomings in independence are regarded as connected to many other weaknesses in the regulatory system such as weak enforcement. On the other hand, many assessments also noted the need to establish additional accountability measures, such as annual reporting, financial reporting and greater transparency of decision making processes at the regulator.

Figure 4. Principles Relating to the Regulator [1]



Source: Standards and Codes Gateway (MCM).

[1] Numbers in the table represent the average percentage share of the applicable and assessed principles for all countries.

25. A shortage of funding and legal authority is a common problem among regulators, with less than half of countries meeting or almost meeting the standard set by IOSCO. Many regulators still lack a stable and adequate level of funding, in particular in countries where funding stems from the state budget. In many countries, the impact of inadequate and uncertain funding on the skill level at the regulator is compounded by a requirement that the regulator pay staff at the public employee pay scale, thereby limiting the regulator's ability to recruit qualified personnel and thus its capacity to discharge its functions properly. In some jurisdictions, there is also a shortage of personnel with the necessary expertise in the country as a whole (for example, qualified accountants and auditors are in short supply in many places). In addition, in some jurisdictions the regulator still lacks sufficient licensing power, which limits its ability to verify the fitness and propriety of market participants, and also investigative and enforcement power, which hinders its ability to supervise compliance and enforce the securities laws and regulations.

Self-regulatory organizations

26. A unique feature of securities regulatory systems is the widespread use of SROs to carry out regulatory functions. The term SRO is used to describe a variety of institutions (exchanges, trade associations, private agencies, etc.), and in the context of the IOSCO Principles is given a broad definition: any organization other than the statutory regulator that is responsible for regulation. The use of self-regulation varies widely, although most countries rely upon it to some extent, particularly for market oversight and regulation of intermediaries. In many countries, a stock exchange is the SRO and regulates listed companies and trading. In a few countries, for example, the U.S., Canada, and Japan, a separate private agency is responsible for regulation of intermediaries, including designing and monitoring of prudential standards and business conduct.

27. The assessments evaluate the adequacy of oversight of SROs by the statutory regulator. The reports found that weaknesses in oversight of self-regulation are widespread; only a quarter of jurisdictions were considered fully compliant with the standard. The most pervasive issue is a lack of inspection programs for SROs, which, in turn, was due to a lack of resources and capacity at the regulator. In a number of countries, there was very little active oversight at all. Many assessors commented on weaknesses in governance structures at self-regulatory organizations, but views of assessors on what constitutes an appropriate structure varied widely. In some jurisdictions, there was an overlap of responsibilities between the regulator and the SRO(s) that resulted in inefficiencies or a lack of activity in the particular area. Many assessors raised concerns regarding the handling of SRO conflicts of interest (for example, the treatment of self-listing at an exchange or the fair treatment of members).

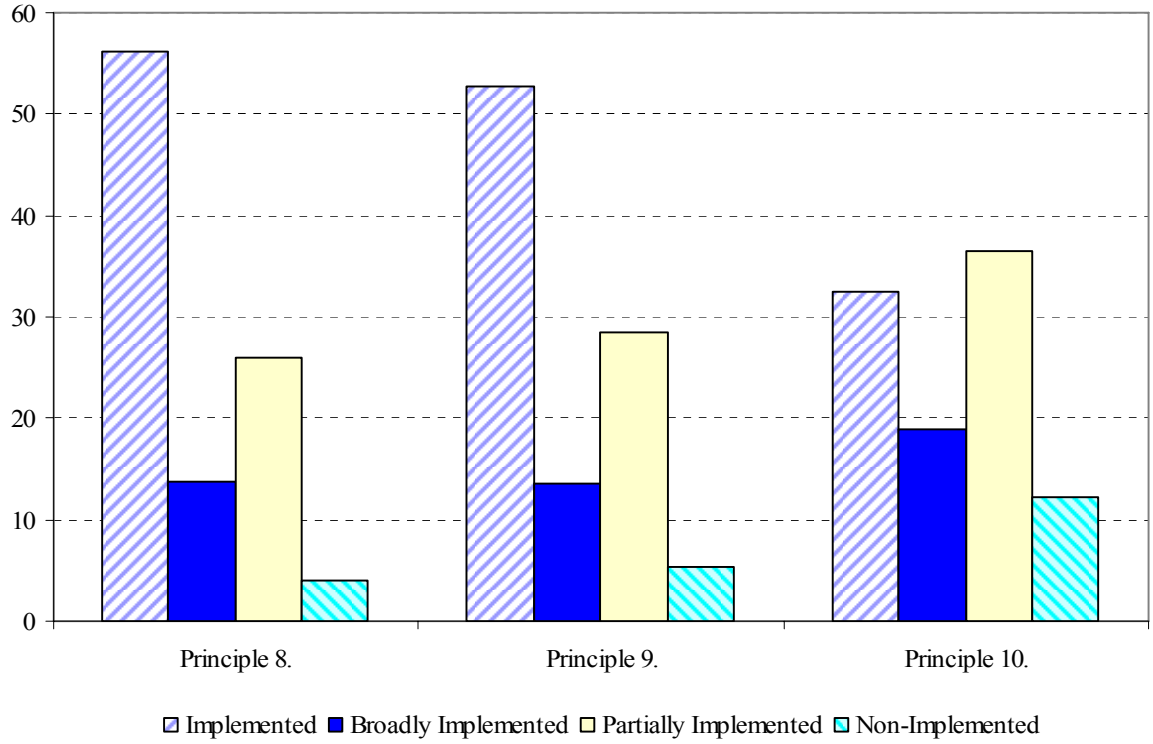
B. Effectiveness of Enforcement

28. 'Enforcement' in this context refers to the agency's ability to both affect compliance with regulation (through active supervision) and its ability to bring an action against a person or entity that has violated regulations. The lower grades in this area reflect weaknesses in enforcement powers and more importantly the inability of many regulators to carry out an effective enforcement program. An effective regulator must have the ability to obtain all necessary information from regulated entities in a timely fashion, both in the course of supervision (such as in inspections) and in extraordinary circumstances (such as in investigations). Regulators must also have the ability to penalize regulated entities that do not comply with rules—either in the course of supervision or as the result of a proven violation of the rules.

29. The assessments noted than in some jurisdictions regulators lack comprehensive investigative and enforcement powers (such as the ability to enter premises to collect information or to compel testimony from individuals). They also showed that many regulators lack the authority to impose administrative sanctions, and therefore had to rely on the criminal authorities for enforcement purposes which hinder their credibility and effectiveness.

30. However, the main problem in enforcement relates to the actual capacity of the regulator to implement adequate supervisory programs, as well as to appropriately use its disciplinary powers. Roughly 50 percent of the countries ranked either partly and not implemented in an assessment of the use of their enforcement powers. Assessors highlighted that in many countries on-site inspections are not a regular part of the supervisory program of the regulator, and the problem is particularly acute concerning exchanges. Finally, in some countries the supervisory programs were deemed adequate, but disciplinary powers were used very scarcely, which hinder the credibility of the regulator. A lack of skilled personnel to conduct both supervisory and enforcement actions was perceived by most assessors to be a consistent problem in many jurisdictions.

Figure 5. Principles for the Enforcement of Securities Regulation [1]



Source: Standards and Codes Gateway (MCM).

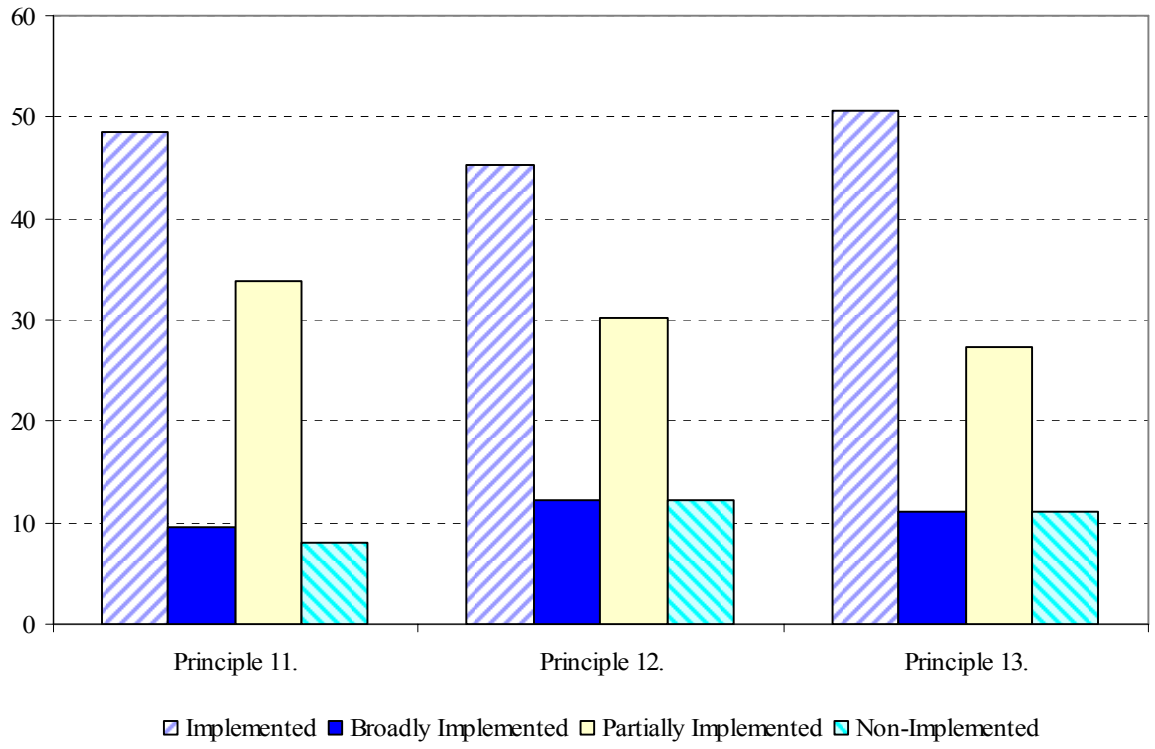
[1] Numbers in the table represent the average percentage share of the applicable and assessed principles for all countries.

31. The poor quality and ineffectiveness of the judiciary system also negatively impacts enforcement efforts in a number of jurisdictions, primarily in emerging market and developing countries. While a supportive judicial environment is a pre-condition to effective regulation, rather than part of the IOSCO standard, a number of assessors noted that the lack of a fair and impartial judiciary that could arbitrate disputes and impose or enforce sanctions within a reasonable timeframe, undermined both the credibility and effectiveness of securities regulation.

Cooperation

32. In an increasingly globalized market it is necessary that regulators be able to share public and non public information with one another. While progress has been made, the assessments show that roughly 40 percent of the jurisdictions still encounter problems in their ability to share public and non public information with domestic and foreign counterparties.

Figure 6. Principles of Cooperation in Regulation [1]



Source: Standards and Codes Gateway (MCM).

[1] Numbers in the table represent the average percentage share of the applicable and assessed principles for all countries.

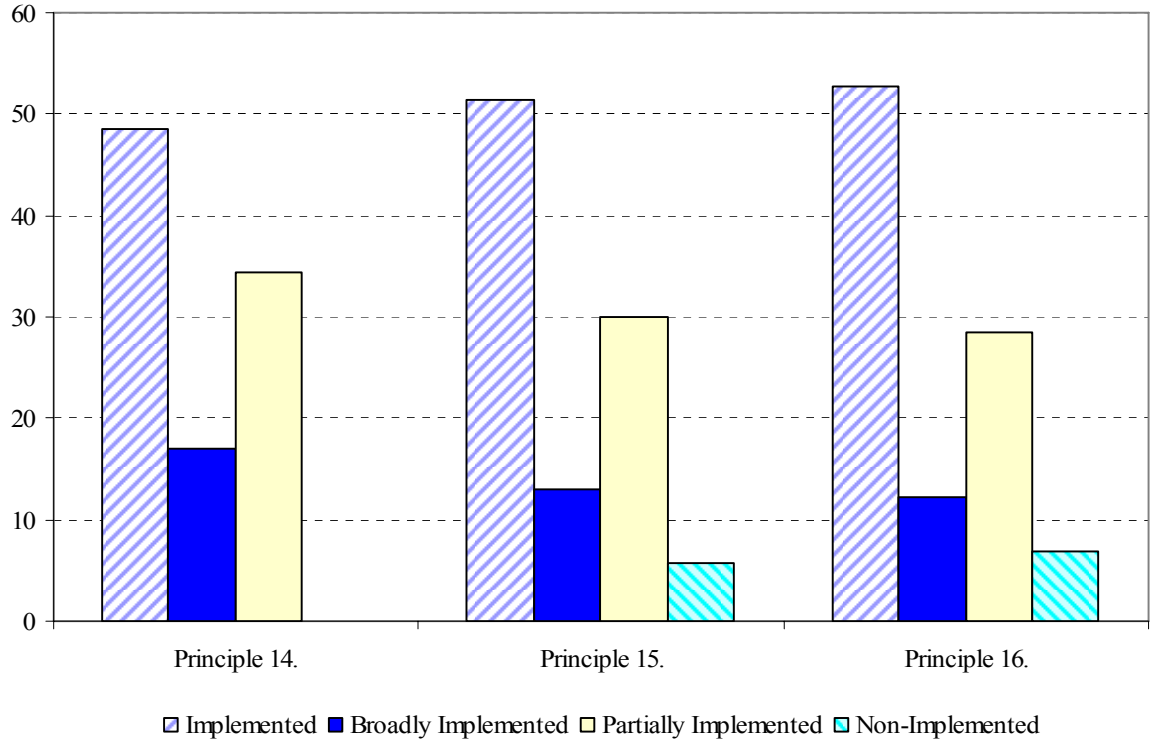
C. Regulation of Public Issuers

33. The quality of disclosure by issuers of securities to investors, and the fair treatment of minority shareholders are key to the credibility of a market place. The market (investors, intermediaries, analyst, etc.) must be able to rely on the information given by management of issuers in order to appropriately value securities—this includes financial information, business plans and disclosure of ownership interests and conflicts of interest. This information must be timely and must be equally accessible to all shareholders simultaneously. Minority shareholders must be given adequate voting rights and notice of meetings and corporate changes, access to information regarding insider transactions and dealings with the company, and fair treatment in take over bids and related party transactions. These protections are particularly important in jurisdictions with concentrated ownership of public issuers, which describes the majority of emerging market and developing countries.

34. Few countries received a failing grade on their disclosure regimes. Most jurisdictions have adequate disclosure in place for initial offerings, requiring that a prospectus complete with audited financial statements be given to investors prior to the purchase of the offering. However, in many countries there is a lack of proper review of prospectus disclosure by the staff of the regulator or exchange, and a lack of skill at the regulator in ensuring that disclosure is meaningful to investors. In these jurisdictions, disclosure may strictly meet criteria set out in legislation but fail to convey to investors and others an adequate understanding of the business plan, business risks and financial condition of the issuer.

35. In a number of countries there was also a lack of continuous disclosure requirements—that is requiring material events to be immediately disclosed to the market, and annual and quarterly reporting. In many developing countries, continuous disclosure requirements either did not exist or were not practically enforced in the case of companies that did not trade on an exchange. A number of assessments concluded that disclosure, particularly of price sensitive information, was not timely and therefore did not provide investors with sufficient transparency.

Figure 7. Principles for Issuers [1]



Source: Standards and Codes Gateway (MCM).

[1] Numbers in the table represent the average percentage share of the applicable and assessed principles for all countries.

36. Most jurisdictions had basic shareholder meetings, notice and voting provisions set out in company law as well as securities regulation. Many, however, had insufficient rules with respect to changes of control (takeover bid and mergers) and related party transactions. Insider transactions in many countries are not reported with sufficient speed to ensure transparency to shareholders. In a number of developing and emerging market countries, the reporting of insider transactions is made to the regulator, but not the public or investors. Following on the theme of a weakness in enforcement of requirements—regulators in many countries were regarded as putting insufficient skill and resource into ensuring that the standards were actually applied.

D. Regulation of Collective Investment Schemes

37. The regulation of collective investment schemes (CIS), including mutual funds, aims to ensure adequate disclosure to investors, appropriate valuation of fund units and the safeguarding of investor's assets from the operator of the fund. CIS are popular retail investments and therefore attract a high degree of customer protection regulation. They are also an important force in the market, and therefore the accurate valuation of their assets may

have systemic importance. Many of the countries assessed had nascent CIS industries—future assessments will reflect a fast-growing industry, particularly in emerging market countries.

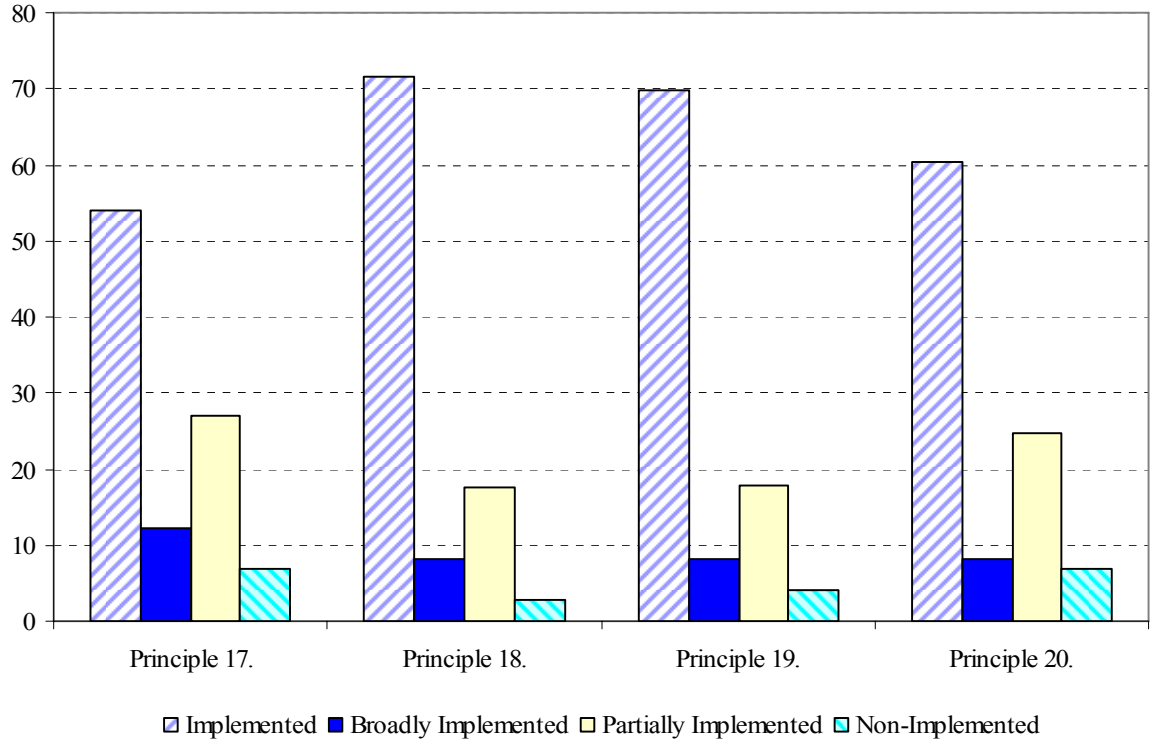
38. While the data show a high level of implementation of the IOSCO standards for CIS, the comments of the assessors suggest that important weaknesses remain in the legal and regulatory framework, as well as in the supervisory arrangements. This outcome may be a consequence assessors' focus on the legal and regulatory framework rather than on its actual implementation, because in many jurisdictions the laws regulating collective investment schemes were relatively new, and because in developing and emerging market countries the CIS industry was very small and underdeveloped. Finally, while compliance monitoring and enforcement is said to be weak in these jurisdictions, lack of enforcement activity may not be sufficiently taken into account in assessing this area.

39. Comprehensive licensing requirements applicable to CIS managers are in place only in about half of the jurisdictions assessed and some emerging and developing markets still lack a licensing regime for CIS managers altogether. Licensing requirements are not comprehensive in many countries: while they usually include a minimum level of capital, other requirements aimed to verify that the entity has the technical and operational capacity to manage CIS are not in place nor are fit and proper requirements for certain controlled functions. Given the importance of licensing as a supervision tool through which standards are set and applied, these shortcomings in licensing regimes are significant.

40. The assessments noted deficiencies in CIS oversight by the regulator. Assessors found that in many jurisdictions licenses are approved without a thorough examination of the CIS manager's technical and operational capabilities to manage funds, and the licensing process does not include an on-site visit. In many jurisdictions, the regulator has not included on-site inspections as a regular part of their on-going supervisory programs. In some of these cases, the regulator is relying on the depository to conduct oversight of the CIS manager; however assessors concluded that, in practice, the depositories were not adequately fulfilling their role and should not be relied on so extensively.

41. Many jurisdictions still lack a comprehensive set of business and market conduct rules for CIS managers, including the regulation of conflict of interest. Assessors also noted that in some jurisdictions where bank platforms were used to market and place CIS, bank personnel was not subject to the same market conduct rules, nor were they supervised with the same intensity as the personnel of the CIS manager. Without appropriate market conduct and business conduct rules, investors are at risk of mis-selling and other abuses. Development of CIS markets will depend on, among other things, the ability of CIS to maintain investor confidence and properly manage conflicts of interest addressed by such rules.

Figure 8. Principles for Collective Investment Schemes [1]



Source: Standards and Codes Gateway (MCM).

[1] Numbers in the table represent the average percentage share of the applicable and assessed principles for all countries.

42. Although this contradicts the grading data, the assessments described important weaknesses in protection of customer assets. Most of the jurisdictions assessed have adequate regulations concerning the legal form and structure of the CIS, but the assessments noted an insufficient separation of customer assets from those of the CIS manager's. In many countries, there are still no rules requiring that separation, which is key to protecting customers from the financial dissolution or bankruptcy of the manager. In other jurisdictions, the rules do exist, but implementation in practice has proven to be more challenging. For example, in jurisdictions where custody by a third party is mandatory, the custodian—which in most cases is a bank—is usually part of the same business group as the fund manager; which weakens investor protection.

43. While in the majority of the countries there are certain disclosure obligations for the public offering of CIS, many weaknesses remain. In most countries, fund managers are required to prepare a prospectus with information on the fund manager and the CIS; however many assessors expressed concern regarding the quality of that disclosure, mainly the analysis of risks which they found insufficient as well as the language and format used for the disclosure, which they believed need to be more investor friendly. In addition, assessors

noted that in many jurisdictions, CIS managers were not required to keep the information included in the prospectus up-to-date, or to inform the market on the occurrence of material events. In some jurisdictions, the regulatory review of the prospectus is very limited. Finally, in many jurisdictions, there are still problems of regulatory arbitrage between different types of CIS, as well as between CIS and insurance products that are similar to CIS, and which are not subject to the same standards of disclosure and supervision.

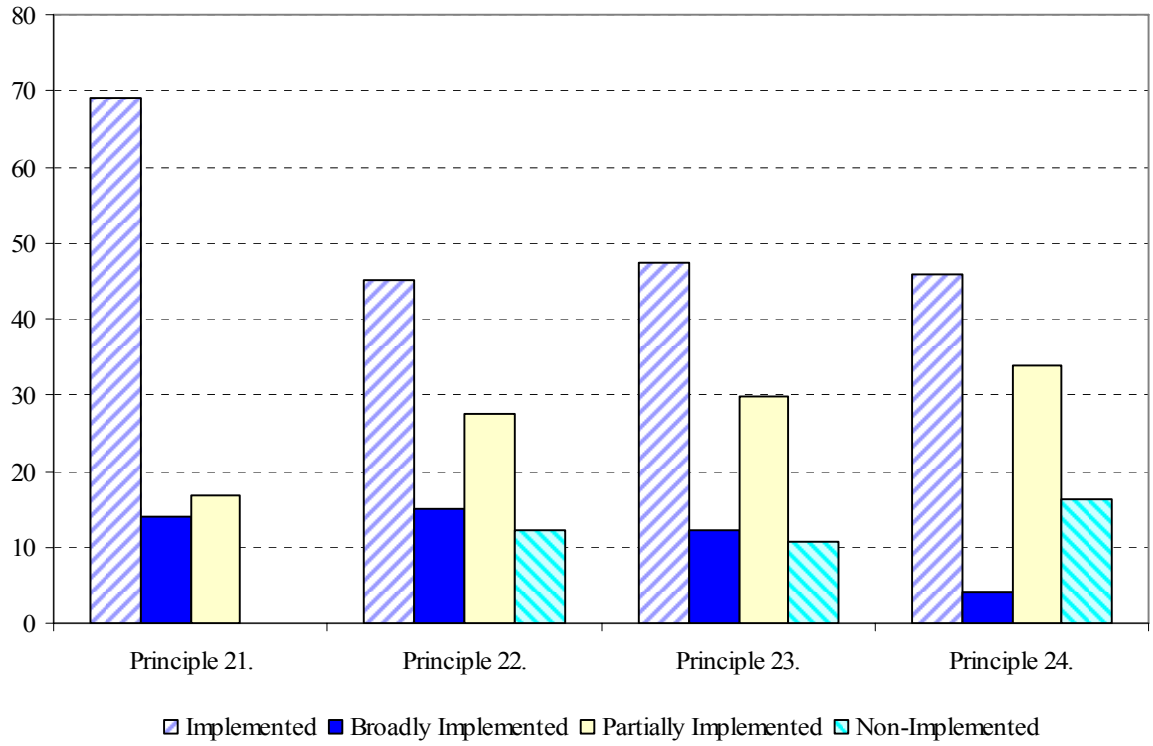
44. Valuation of illiquid assets is the key challenge for the industry and the regulator. This problem is particularly acute for developing markets where the majority of the securities available for investment are illiquid, and thus the prices derived from the trade carried out in the market might not be a reliable indicator of their true market value. Difficulties in valuation of some assets make it very difficult for CIS managers to value the CIS portfolio, as a whole. Jurisdictions have come up with different ways to address this problem, including subjecting valuation of illiquid assets to a third-party validation, and the development of a valuation methodology for the whole market with the involvement of the regulator. In addition, many assessors noted as a problem the lack of clear rules regarding how to proceed in cases where there have been errors in the pricing process. In some jurisdictions, there are explicit provisions that require fund managers to notify the regulator of pricing errors that reach certain thresholds, as well as to compensate investors for any loss arising from the error with their own capital; however in many jurisdictions regulations are silent.

E. Regulation of Market Intermediaries

45. The regulation of market intermediaries has three main objectives: to protect client assets from insolvency of the firm or appropriation by the firm or its employees; guard against defaults and sudden disruption to the market, either through sudden insolvency or settlement failure; and, to ensure that intermediaries are fair and diligent in dealing with their clients. Regulation, therefore, sets licensing standards (limiting the market place to those with sufficient resources and qualification), prudential standards (protecting against sudden financial failure), internal controls and risk management standards (reducing the possibility of default or appropriate of client assets), and business conduct rules (ensuring proper handling of client accounts).

46. The assessments found regulation of intermediaries to be an area of weakness. While licensing standards and a supervisory framework may be in place, many regulators lack the skilled staff to oversee market intermediary activity effectively or to set detailed standards for internal controls, risk management or adequate prudential requirements. This lack of in-depth understanding prevents regulators from executing effective inspections and examinations and from detecting potential insolvencies. The regulation of market intermediaries in jurisdictions with these weaknesses, takes on a ‘form over substance’ character, with formal reporting and inspection programs that do not yield results.

Figure 9. Principles for Market Intermediaries [1]



Source: Standards and Codes Gateway (MCM).

[1] Numbers in the table represent the average percentage share of the applicable and assessed principles for all countries.

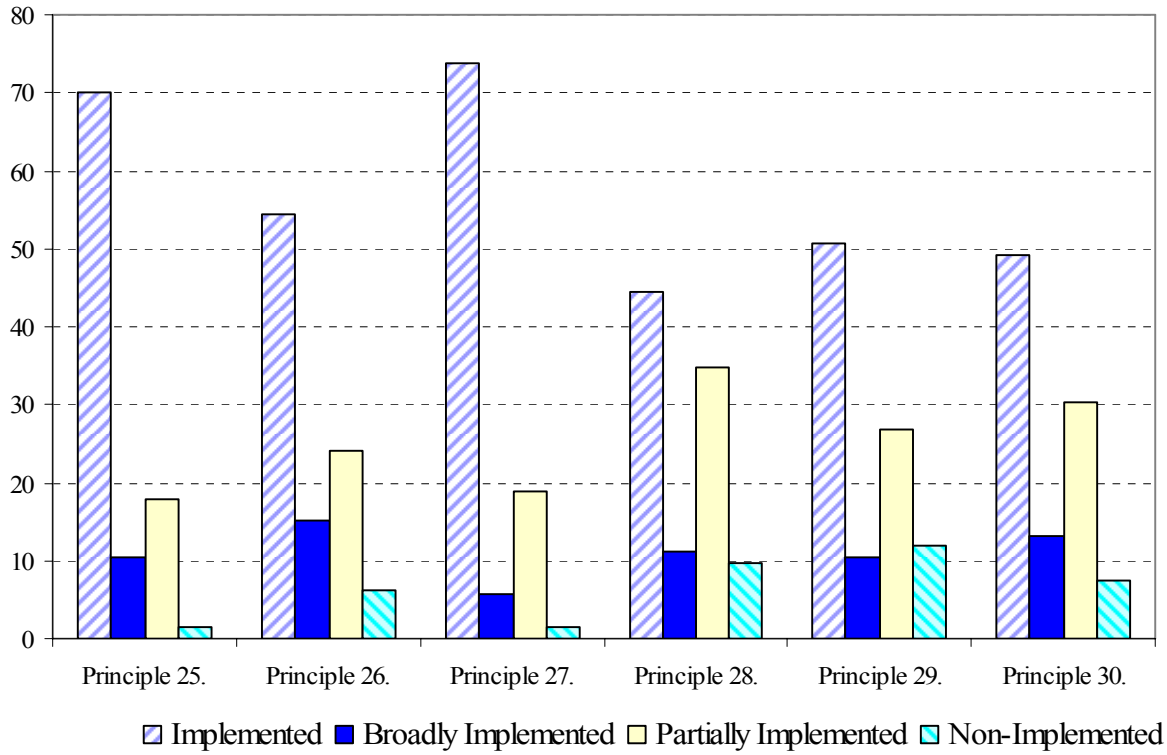
F. Regulation of Secondary Markets

47. Secondary markets are regulated to ensure the efficiency and credibility of the markets as mechanisms for pricing and transfer of securities.[13] Exchange and other public trading systems are subject to licensing requirements, including standards applicable to information technology systems and risk management, and are subject to on-going supervision, including inspections and reporting requirements. Potential sources of market disruption are addressed through the regulation of clearing, settlement and depository services, including risk management mechanisms designed to ensure that intermediaries

[13] Key to transfer of securities and credibility of market place is, of course, the clearing and settlement system. IOSCO Principle 30 evaluates clearing and settlement systems but this has been superseded by the more detailed CPSS/IOSCO Recommendations for Securities Settlement Systems. Since the adoption of these recommendations, the IOSCO Principles assessments have not included an assessment of Principle 30. We have, accordingly, left out any discussion of clearing and settlement systems.

settle their market obligations in a timely and orderly manner. Market activity is subject to market abuse rules, including prohibitions on trading on insider information, market manipulation and misrepresentation.

Figure 10. Principles for the Secondary Market [1]



Source: Standards and Codes Gateway (MCM).

[1] Numbers in the table represent the average percentage share of the applicable and assessed principles for all countries.

48. The IOSCO Principles cover these issues in Principle related to secondary markets (Principles 26–30), which have mixed levels of implementation. Overall, oversight of secondary markets operations and regulatory functions remains a challenge in many jurisdictions. Regulators struggle with a lack of capacity to build the necessary knowledge and skill required to understand and monitor markets. There is a lack of attention to technology, an issue of ever-growing importance, and an over-reliance on formal rules and reporting as a means of conducting oversight.

49. As with the risk management of market intermediary activity, there are sometimes limitations on the assessor's knowledge and understanding of market operations and the risks they entail. The effectiveness of oversight, rules, and practices is undermined by this gap in understanding.

VI. CONCLUSION

50. Our analysis of the IOSCO assessments in 74 countries provides a remarkably consistent picture of the strengths and weaknesses of regulatory systems across the globe. Four main areas of concern emerged from the analysis: (a) weaknesses in supervisory practices, including inspections; (b) weaknesses in enforcement; (c) poor valuation rules for investment funds; and (d) a lack of understanding and oversight of risk management and internal control practices in market participants[14].

51. Enforcement of compliance with rules and regulations emerged as the overriding weakness in regulatory systems. Regulators rely on a continuum of operations to effect regulation: beginning with routine inspections and reporting and culminating in special investigations and enforcement actions. We observed a chronic lack of skill and knowledge in the practice of inspections and the use of reporting tools. Further, there was a lack of resources, skill and legal authority required to effectively undertake investigations and bring enforcement actions. While the regulator may be able to react to market needs with new laws and new regulatory guidance, it appears it is much more difficult to ensure these laws are complied with and the lack of ability to do so undermines the whole regulatory process. This is of particular concern since the success of securities markets depends, to a great degree, on market confidence, which in turn can be adversely affected by a lack of credible regulation.

52. Weaknesses in enforcement may also be related to another key finding—that of insufficient independence of regulators. The fully-independent and independently-funded securities regulator, even where it exists, is a relatively recent phenomenon. Many countries still resist allowing full independence and thus regulators can be mired in political or bureaucratic considerations that prevent them from fully engaging in regulation and supervision.

53. Valuation rules for investment funds is a difficult and technical area of regulation that requires serious attention. In many countries, we found that inadequate attention is paid to reviewing valuation practices, particularly in markets where funds would have significant holdings in relatively illiquid securities and should not rely entirely on the price given by an organized market or exchange. Risk management and internal controls at market participants is another difficult and technical area that emerged as a source of weakness in many countries. Many regulators do not have staff skilled enough to properly understand the activity of market participants and the risks that these activities produce and therefore cannot

[14] In our introduction we identified pre-conditions to securities regulation, such as company and property law, accounting and auditing standards as important elements in effective regulation. We would reiterate here that these would seem to be more important in some assessed countries than the areas of concern discussed here but, again, these are beyond the remit of an IOSCO assessment or our analysis.

effectively set standards for risk management and internal control nor effectively evaluate the practices employed by firms.

54. These findings enhance our understanding of financial sector regulation and challenges facing policy makers in improving conditions in local markets. The findings will be immediately useful as guidance to financial sector surveillance work being undertaken by the IMF, the World Bank and others, pointing in the direction of areas that require particular scrutiny. In addition, the paper's findings can be used as a tool to prioritize technical assistance that the IMF provides to countries and as useful input to other technical assistance providers and IOSCO in formulating work programs. In further developing its technical assistance program, the IMF should focus on the practice areas of enforcement and inspections and on the technical areas of risk management and valuation of portfolios in investment funds

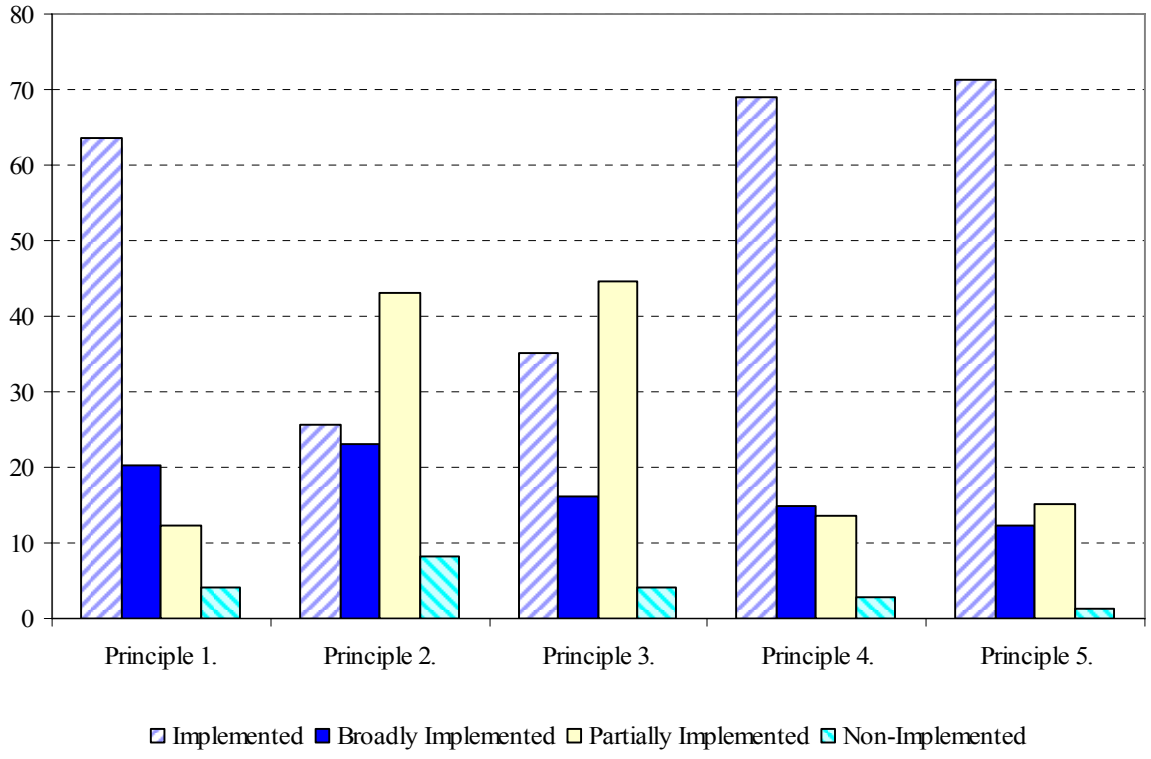
55. The findings are potentially valuable to understanding the source of vulnerabilities in the financial sector and providing countries with policy advice in addressing these vulnerabilities, although much work remains to be done in connecting the weaknesses in securities markets regulation to crisis or potential crisis events. Future work may establish these connections and in addition, increase our understanding of the value of institutional (including regulatory) strengthening in view of increased cross-border trading and capital flows.

DETAILED ANALYSIS OF THE ASSESSMENT DATA

Strength of the Regulator and Regulatory Structure (Principles 1–5)

56. The IOSCO Principles cover these issues in the Principles related to the regulator (1–5), to enforcement (8-10) and cooperation (11–13). The analysis of these sets of Principles shows that ensuring an adequate level of independence, powers and resources remain a key challenge for most regulators, even in industrialized countries. In addition, most countries still have deficiencies in the development of adequate programs for the supervision of market participants and the credible use of their enforcement powers.

Figure 11. Principles Relating to the Regulator [1]



Source: Standards and Codes Gateway (MCM).

[1] Numbers in the table represent the average percentage share of the applicable and assessed principles for all countries.

Responsibilities

57. The legal framework of most countries defines clearly the regulator's responsibilities and authority; thus the high level of implementation of Principle 1, with 80 percent of the countries receiving implemented and broadly implemented grades. However, in a number of countries with different authorities sharing responsibility for regulation and supervision of securities markets, coordination and cooperation arrangements are non-existent or are not being used effectively, with an overall weakening effect on the regulatory framework.

Independence and accountability

58. Achieving an appropriate balance between independence and accountability remains a challenge in most countries: Principle 2 exhibits very low levels of implementation, with less than 50 percent of the countries in the implemented and broadly implemented categories. Assessors have observed that in many countries the regulator still has direct ties to the government. Examples include representatives of the government sitting on the board of the regulator, the discretionary appointment and removal of board members by the government, funding through the state budget, and the retention of certain powers by the government. While these arrangements might ensure a regulator's accountability to the government, they could also allow the government to exercise direct influence on the day-to-day operations of the regulator, thus weakening its independence. Additional protection of staff is also needed to strengthen the regulator's ability to make sensitive decisions in an objective and timely manner.

Funding, resources, and powers

59. The lack of adequate resources and legal authority is a common problem faced by many regulators, significantly affecting the implementation of Principle 3. This principle exhibits low levels of implementation, with less than 50 percent of the countries in the categories of fully and broadly implemented. Many regulators still lack a stable and adequate level of funding, in particular, in countries where funding stems from the state budget. In many countries, the impact of inadequate and uncertain funding is compounded by regulations that require the regulator to pay staff at the public employee pay scale, thereby limiting the regulator's ability to recruit qualified personnel and thus its capacity to discharge its functions properly. In some jurisdictions, there is also a shortage of personnel with the necessary expertise in the country, as a whole. In addition, in some jurisdictions, the regulator still lacks sufficient licensing power, which limits its ability to verify the fitness and propriety of market participants, and also investigative and enforcement power, which hinders its ability to supervise compliance and enforce the securities laws and regulations.

Transparency and fair process

60. Most countries have made significant progress in transparency—thus the high level of implementation of Principle 4. Around 80 percent of the countries are in the categories of implemented and broadly implemented. However, there is still a need to provide greater transparency to the different actions taken by the regulator, in particular, regulatory measures, including interpretations and explanatory notes. Publication of financial statements, or other means to provide transparency on the use of resources, should also be strengthened. Although most regulators have developed websites, much of this information has not yet been included in them.

61. Most countries have regulations that subject their staff to high standards of conduct and, therefore, Principle 5 shows very high levels of implementation. Around 80 percent of the countries are in the categories of implemented and broadly implemented. However, while many countries have regulations that deal with specific ethical issues, provisions regarding staff or board member participation in securities transactions still need to be strengthened, and all existing provisions should be codified to make the system more robust. In addition, there is a need to develop more active means to monitor compliance.

Enforcement

62. Altogether these group of Principles exhibit very low levels of implementation.

Legal authority

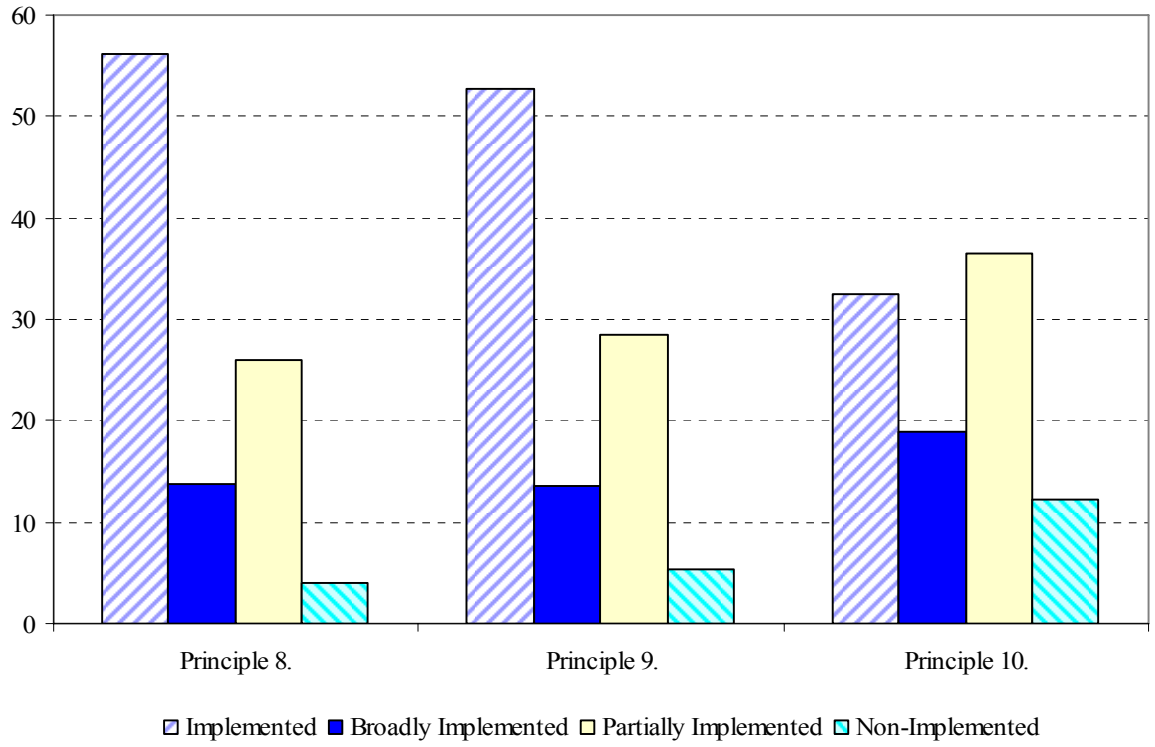
63. The lack of investigative and surveillance powers has affected the level of implementation of Principles 8 and 9, with roughly a third of the countries assessed still exhibiting significant deficiencies in their regulatory frameworks. The numbers might be somewhat skewed by the fact that many assessors chose not to downgrade these Principles and only affect the grade in Principle 10.

64. The assessments noted the lack of authority to obtain information through inspections, with regulators unable to enter the premises of regulated entities in some cases. With respect to investigations, in a number of jurisdictions regulators were unable to subpoena third parties, which could hinder their ability to investigate and sanction unfair practices.

65. The assessments clearly show that many regulators lack the authority to impose administrative sanctions, and therefore had to rely on the criminal authorities for enforcement purposes, which hinder their credibility and effectiveness. In many cases, the regulator was given the power to impose administrative sanctions, but the range of sanctions available was not adequate either (i) because they were not severe enough to have a deterrent effect (for example the fines were too low), and therefore undermine the credibility of the regulatory

program; (ii) or in fact, because they were too severe (for example, the only sanctions available was delicensing), and therefore could only be used in extreme situations, with lesser violations going uncorrected.

Figure 12. Principles for the Enforcement of Securities Regulation [1]



Source: Standards and Codes Gateway (MCM).

[1] Numbers in the table represent the average percentage share of the applicable and assessed principles for all countries.

Enforcement capacity

66. Less than half of the assessments found that Principle 10 was either implemented or broadly implemented. Approximately 40 percent were partly implemented, and a substantial percentage (over 13 percent) were not implemented.

67. In countries where the authority to regulate and supervise the securities market is fragmented among different entities, assessors find gaps in the actual exercise of supervisory and enforcement powers, the most common cases being the supervision of credit institutions in their investment services activities. In many countries, regulators do no use on-site inspections as a regular part of their supervisory programs, a weakness particularly acute in the supervision of stock exchanges. In an important number of countries, regulators use

external auditors to conduct on-site inspections of regulated firms. While the IOSCO standards do not prohibit the use of auditors for this purpose, assessors found that the auditors were generally not sufficiently supervised by the regulator. Typically, the regulator outsourced the inspection function to the audit firms because of a shortage of in-house regulatory resources; however, the shortage of resources sometimes results in insufficient supervision of the work of the outside firm.

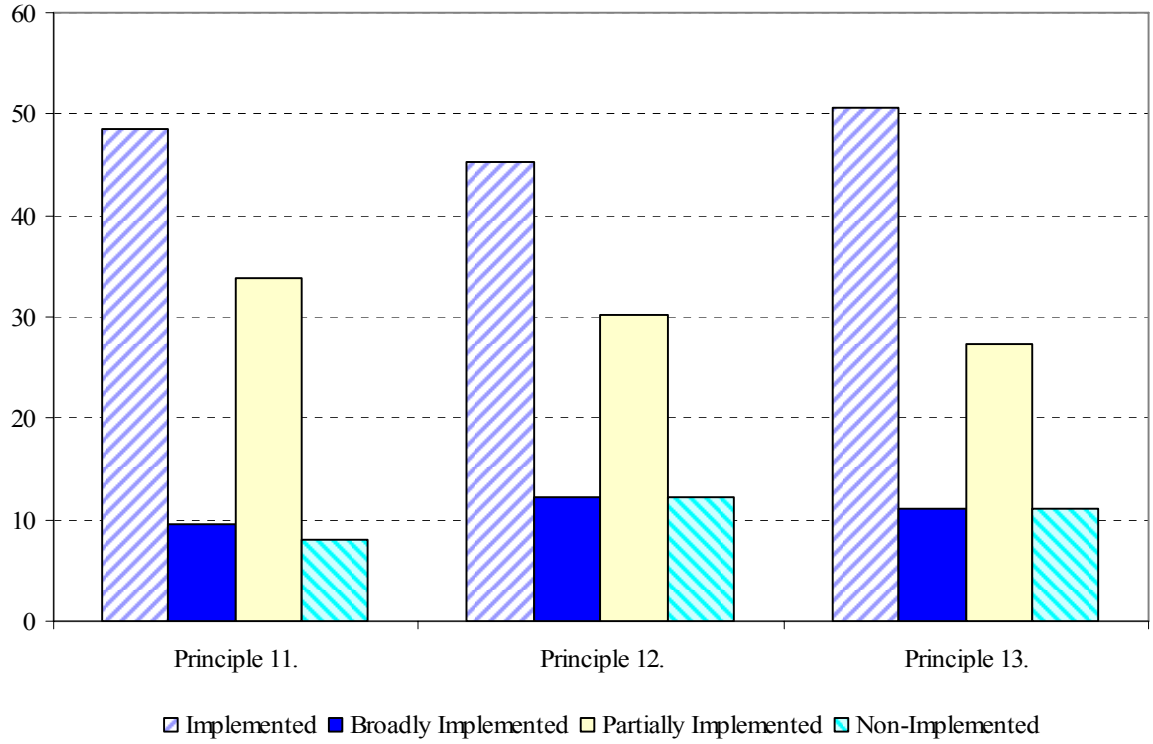
68. In some countries, the supervisory programs were deemed adequate, but disciplinary powers were used very scarcely, which undermines the credibility of the regulator. It is important to note, however, that the lack of powers to impose administrative sanctions and the lack of a wide range of sanctions, as discussed above, have been factors that in many cases have affected the enforcement program of the regulator. Finally, a lack of skilled personnel to conduct both supervisory and enforcement actions was perceived by most assessors to be a consistent problem in many jurisdictions.

69. The poor quality and ineffectiveness of the judiciary system also negatively impacts effective enforcement in a number of jurisdictions, primarily in emerging market and developing countries. While this is technically a "pre-condition" and is not covered by the key questions contained in Principle 10, a number of assessors noted that a fair and impartial judiciary that can arbitrate disputes and impose or enforce sanctions within a reasonable timeframe, is important for both the credibility and effectiveness of securities regulation.

Cooperation

70. The assessments also evaluate how the regulator shares enforcement information with foreign and domestic counterparts. Although these Principles do not exhibit very low levels of implementation, the grading of Principles 11 and 12 does show that roughly 40 percent of the jurisdictions still encounter problems in their ability to share public and non public information with domestic and foreign counterparties.

Figure 13. Principles of Cooperation in Regulation [1]



Source: Standards and Codes Gateway (MCM).

[1] Numbers in the table represent the average percentage share of the applicable and assessed principles for all countries.

71. A surprising finding is that in some countries there are still no clear provisions that allow regulators to share information at the domestic level. In addition, many domestic regulators have not actively pursued the implementation of effective mechanisms for coordination and exchange of information. Rather, in many cases exchanges of information occurs only on an ad-hoc basis and no Memorandum of Understanding or other mechanisms of coordination are in place.

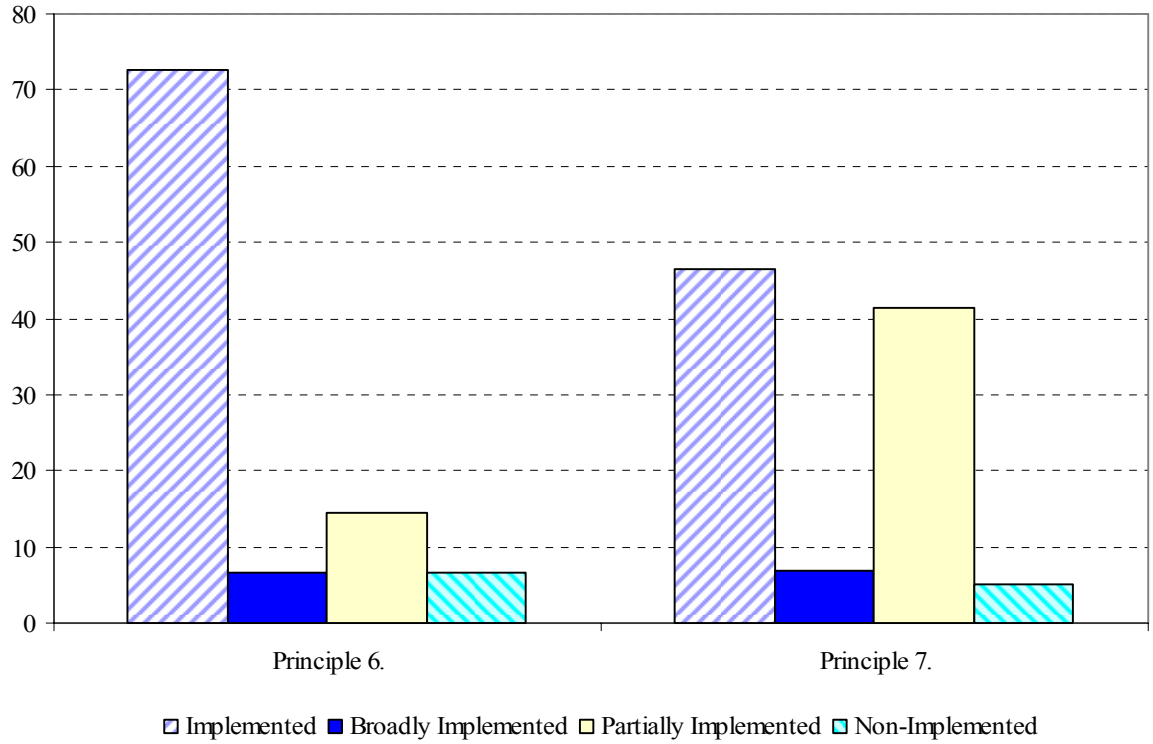
72. A less surprising finding was the fact that in many countries there are still limitations to the ability of regulator to share information with foreign counterparties. There are three main obstacles for effective sharing of information: (i) the lack of authority to share confidential information, including banking information, (ii) the condition existent in many jurisdictions that information can only be shared under "dual illegality", that is, the misconduct investigated by the jurisdiction requesting assistance has to constitute a misconduct for the jurisdiction of the authority that receives it, and (iii) the lack of authority to share information that relates to criminal matters.

73. All these limitations as described by assessors lead us to conclude that the grades might not reflect the actual state of implementation, and that the level of implementation of these Principles might in fact be lower. The fact that only a third of the countries who are members of the IOSCO have been able to sign the IOSCO MOU, support this view.

Use of self-regulatory organizations

74. The IOSCO Principles cover the analysis of SROs in Principles 6 and 7. These Principles require that in countries where SROs exist, the regulatory framework ensure an appropriate use of them as well as adequate oversight. The analysis of these Principles show that oversight of self-regulatory functions continues to be a challenge in many jurisdictions. Regulators are often unable to devote sufficient time and skill to overseeing self-regulatory functions, despite the fact that in many jurisdictions self-regulation plays a vital role.

Figure 14. Principles of Self-Regulation [1]



Source: Standards and Codes Gateway (MCM).

[1] Numbers in the table represent the average percentage share of the applicable and assessed principles for all countries.

Appropriate use of SROs

75. Most jurisdictions were deemed to make appropriate use of self-regulation and self-regulatory organization (Principle 6)—although there were significant differences in findings for assessments undertaken before the methodology was in place.

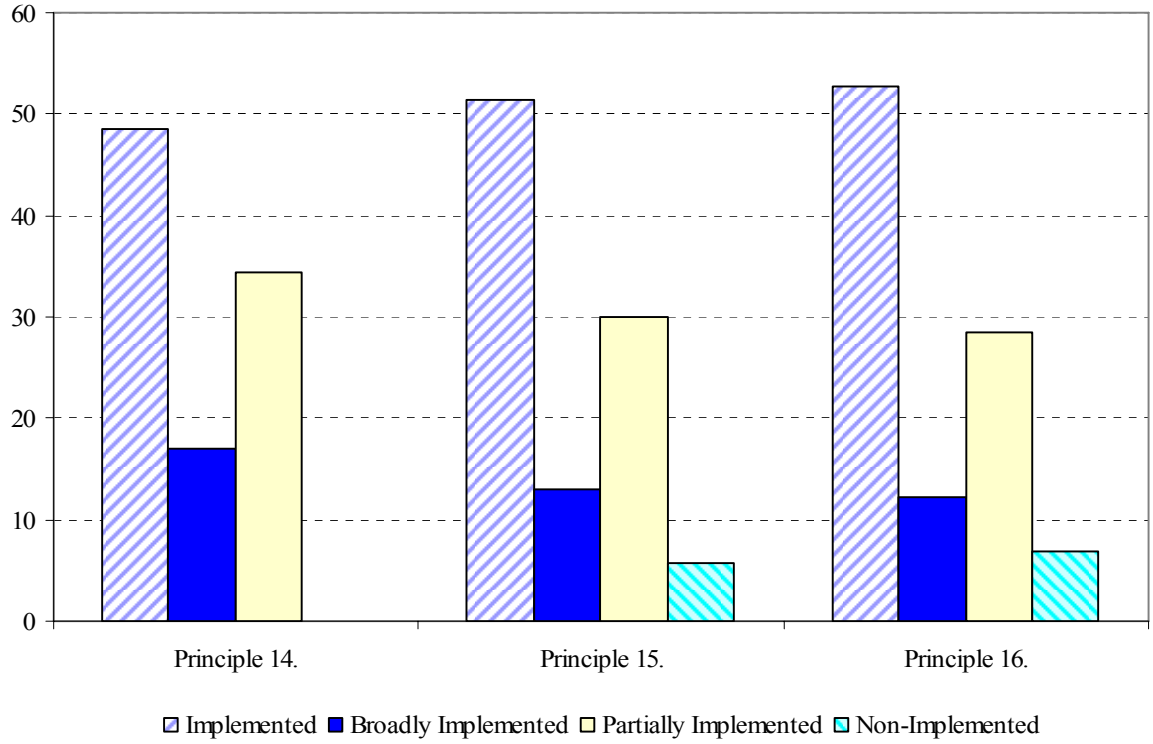
Oversight

76. Weaknesses in oversight of self-regulation are widespread; only a quarter of jurisdictions were fully implemented under Principle 7. The most pervasive issue is a lack of inspection programs for self-regulatory organizations, which, in turn, was due to a lack of resources and capacity at the regulator. In a number of countries, there was very little active oversight at all. Many assessors commented on weaknesses in governance structures at self-regulatory organizations, but views of assessors on what constitutes an appropriate structure varied widely. In some jurisdictions, there was an overlap of responsibilities between the regulator and the self-regulatory organization(s) that resulted in inefficiencies or a lack of activity in the particular area. Many assessors raised concerns regarding the handling of SRO conflicts of interest, for example, the treatment of self-listing at an exchange or the fair treatment of members.

Regulation of public issuers (principles 14–16)

77. The IOSCO Principles cover these issues in the Principles related to issuers (Principles 14–16). Although many countries exhibit acceptable levels of implementation, the grading does show that at least a third of the countries still have deficiencies in the way they regulate and supervise issuers. In particular, the assessors found that there is a need to enhance dissemination and quality of price-sensitive information, better protect interests of minority shareholders, improve application of international accounting and audit standards, and upgrade training and oversight of the accounting and audit professions.

Figure 15. Principles for Issuers [1]



Source: Standards and Codes Gateway (MCM).

[1] Numbers in the table represent the average percentage share of the applicable and assessed principles for all countries.

Disclosure

78. IOSCO Principle 14 measures the jurisdictions setting and enforcement of disclosure standards both at the time of initial offering and continuously thereafter. Significantly no country received a 'not implemented' rating, although less than fifty percent are fully implemented. Most jurisdictions have adequate disclosure in place for initial offerings, requiring a prospectus complete with audited financial statements be given to investors prior to the purchase of the offering (hence a grade of at least partly implemented). However, in many countries there is a lack of proper review of prospectus disclosure, and a lack of skill at the regulator in ensuring that disclosure is meaningful to investors.

79. In a number of countries, there was also a lack of continuous disclosure requirements—that is requiring material events to be immediately disclosed to the market, and annual and quarterly reporting. In many developed countries, continuous disclosure requirements either did not exist or were not practically enforced in the case of companies that did not trade on an exchange, since rules for and monitoring of continuous disclosure rested with the exchanges. A number of assessments concluded that disclosure, particularly

of price-sensitive information, was not timely and therefore did not provide investors with sufficient transparency.

Minority shareholders rights

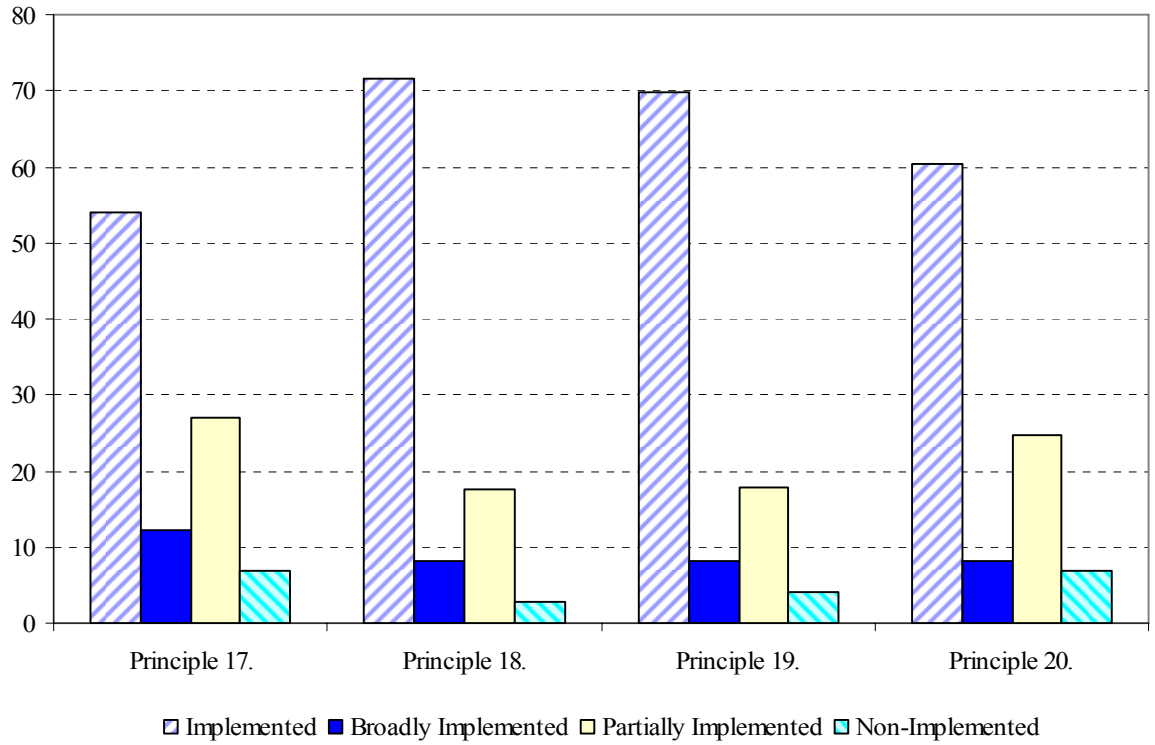
80. Minority shareholder protection is measured under Principle 15. Most jurisdictions had basic shareholder meetings, notice and voting provisions set out in company law as well as securities regulation. Many, however, had insufficient rules with respect to changes of control (takeover bid and mergers) and related party transactions. Insider transactions in many countries are not reported with sufficient speed to ensure transparency to minority shareholders. In a number of developing and emerging market countries, the reporting of insider transactions is made to the regulator, but not the public or investors. The definition of 'insider' was loose enough in some cases to allow circumvention of reporting requirements, opening up the potential for abuse of insider knowledge. Following on the theme of a weakness in enforcement of requirements—regulators in many countries were regarded as putting insufficient skill and resource into ensuring that the standards were effectively applied.

Accounting and auditing standards

81. Accounting and auditing standards are measured by Principle 16. While most countries have applied accounting standards of one form or another, some did not measure up to international standard. With the widespread introduction of International Financial Reporting Standards (IFRS) this Principle will both be easier to assess (as a consensus is achieved on an acceptable standard) and more widely implemented. Having said that there were countries with large markets, which fell short of very basic requirements, for example, with no mandatory cash flow statement included in financial statements. Audit standards are applied to public companies in many countries, but there are often shortcomings in the standards. The IOSCO Methodology places a great emphasis on auditor independence and this proved to be an area of weakness. Assessors noted the lack of quality auditing and accounting professionals in some markets—while this is not an explicit requirement of the Principle it is a key precondition to effective regulation and without such resources, even well-set standards will not be enforced.

Regulation of Collective Investment Schemes (Principles 17–20)

Figure 16. Principles for Collective Investment Schemes [1]



Source: Standards and Codes Gateway (MCM).

[1] Numbers in the table represent the average percentage share of the applicable and assessed principles for all countries.

Licensing of CIS operators

82. Comprehensive licensing requirements, applicable to CIS managers, are in place only in around half of the jurisdictions assessed, thus the medium level of implementation of Principle 17. Some emerging and developing markets still lack a licensing regime for CIS managers. In addition, even in the countries where an authorization regime is in place, the requirements are not comprehensive: while they usually include a minimum level of capital, other requirements aimed to verify that the entity has the technical and operational capacity to manage CIS are not in place. In many countries, there are no fit and proper requirements (that is, background checks and specific qualifications) for certain controlled functions at the manager or operator. In addition, many jurisdictions still lack a comprehensive set of market conduct rules for CIS managers, including the regulation of conflict of interest. Assessors

also noted that in some jurisdictions where bank platforms were used to market and place CIS, bank personnel was not subject to the same market conduct rules, nor was supervised with the same intensity than the CIS manager personnel.

83. In addition, assessors noted significant deficiencies in CIS oversight by the securities regulator. Assessors highlighted the need to strengthen oversight mechanisms of the CIS industry by the securities regulator. Assessors noted deficiencies in the authorization process for CIS managers, which in many jurisdictions is not based on a thorough examination of the CIS manager's technical and operational capabilities to manage funds and does not include an on-site visit as part of the process. Also, assessors highlighted that in some jurisdictions, the review of the prospectus is very limited. In addition, assessors noted that in many jurisdictions, the regulator has not included on-site inspections as a regular part of their on-going supervisory programs. In some of these cases, the regulator is relying on the depository to conduct oversight of the CIS manager; however, assessors believe that in practice the depositories were not adequately fulfilling their role.

Investors' assets protection

84. In spite of the level of implementation of Principle 18, the assessments show important weaknesses in protection of customer assets. Most of the jurisdictions assessed have adequate regulations concerning the legal form and structure of the CIS. However, weaknesses remain on the separation of investors' assets from CIS managers' assets. In many countries, there are still no rules that require that separation. In others, the rules do exist, but implementation in practice has proven to be more challenging. For example, in jurisdictions where custody by a third party is mandatory, the custodian—which is most cases is a bank—is usually part of the same group as the fund manager; which to a certain degree weakens investors protection.

Disclosure obligations

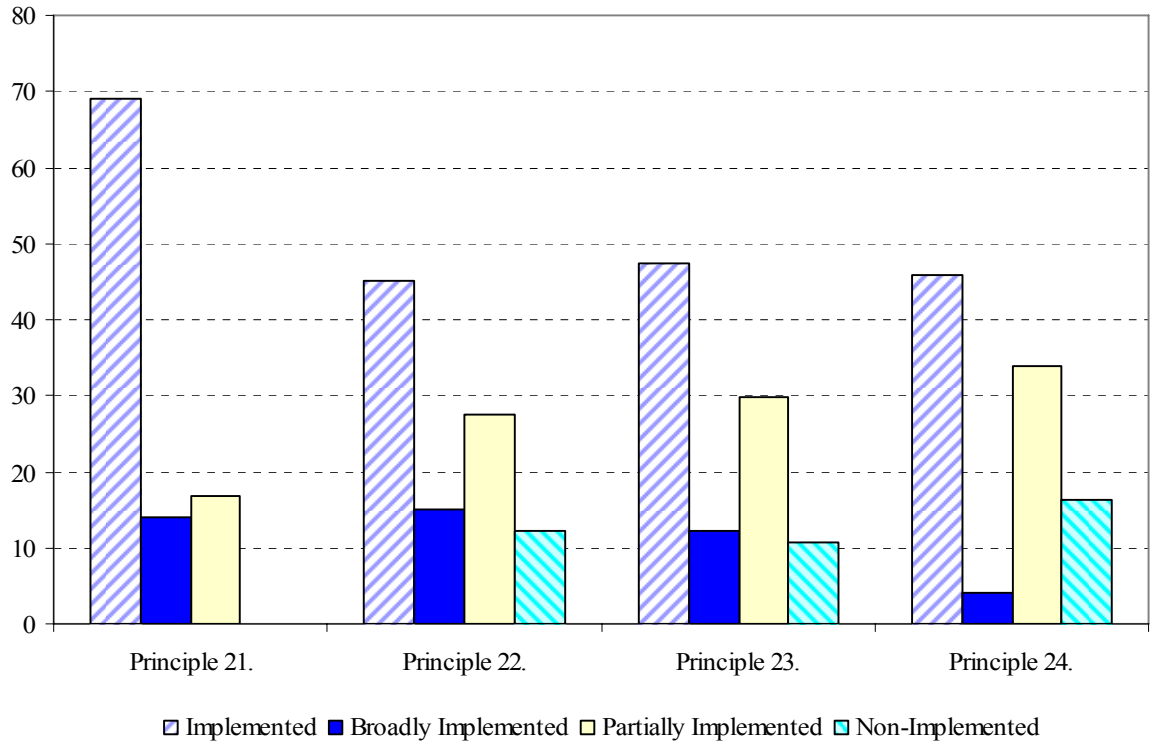
85. While in the majority of the countries there are certain disclosure obligations for the public offering of CIS, many weaknesses remain for a full implementation of Principle 19. In most countries, fund managers are required to prepare a prospectus with information on the fund manager and the CIS; however, many assessors expressed concern regarding the "quality" of that disclosure, mainly the analysis of risks, which they found insufficient as well as the "language and format" used for the disclosure, which they believed need to be more investor friendly. In addition, assessors noted that in many jurisdictions CIS managers were not required to keep up-to-date the information included in the prospectus or to inform the market on the occurrence of material events. Finally, in many jurisdictions there are still problems of regulatory arbitrage between different types of CIS, as well as between CIS and insurance products that are similar to CIS, which are not subject to the same standards of disclosure and supervision.

Asset valuation

86. Valuation of illiquid assets is the key challenge for the implementation of Principle 20. This problem is particularly acute for developing markets where the majority of the securities available for investment are illiquid and thus the prices derived from the trade carried out in the market, might not be a reliable indicator of their true market value. This problem makes it very difficult for CIS managers to value the CIS portfolio. Jurisdictions have come up with different ways to address this problem, including subjecting valuation of illiquid assets to a third party validation, and the development of a valuation methodology for the whole market with the involvement of the regulator. In addition, many assessors noted, as a problem, the lack of clear rules regarding how to proceed in cases where there have been errors in the pricing process. In some jurisdictions, there are explicit provisions that require fund managers to notify the regulator pricing errors that reach certain thresholds, as well as to compensate investors for any loss arising from the error with their own capital; however, in many jurisdictions the regulations are silent.

Regulation of Market Intermediaries (Principles 21–24)

Figure 17. Principles for Market Intermediaries [1]



Source: Standards and Codes Gateway (MCM).

[1] Numbers in the table represent the average percentage share of the applicable and assessed principles for all countries.

Licensing of financial intermediaries

87. Generally, countries have adequate licensing criteria and licensing processes setting entry standards (capital, etc.) for a range of market participants. Thus, the ratings under Principle 21 are relatively high. In some countries, there were groups of intermediaries, usually non-exchange or non-SRO members, that fell outside of the regulatory net, either because they are not caught by the regulatory framework at all or in practice they are not regulated. In some cases, there were gaps in regulation because all market intermediary rules appear in the rules of the exchange or SRO and not in general securities legislation. The inability to remove a license was seen as an undue constraint on regulators in some countries (usually the power to de-license in these countries remains with the government ministry).

Capital adequacy

88. Implementing appropriate capital requirements is an unmet challenge in many jurisdictions. Thus, Principle 21 had one of the highest levels of "not implemented" grades and less than a third of countries received a "fully implemented" rating. The main problem is that capital requirements do not have a sufficient risk component. In some jurisdictions, the capital level is a flat number, which does not reflect risks of the market intermediaries activities. In other cases, the assessor deemed the risk components to not properly reflect risks to the intermediary. In many jurisdictions, there is also inadequate financial reporting from intermediaries and no early warning system that would alert regulators to falling capital or potential insolvencies. In some cases, the capital requirements lacked a liquidity component.

Risk management

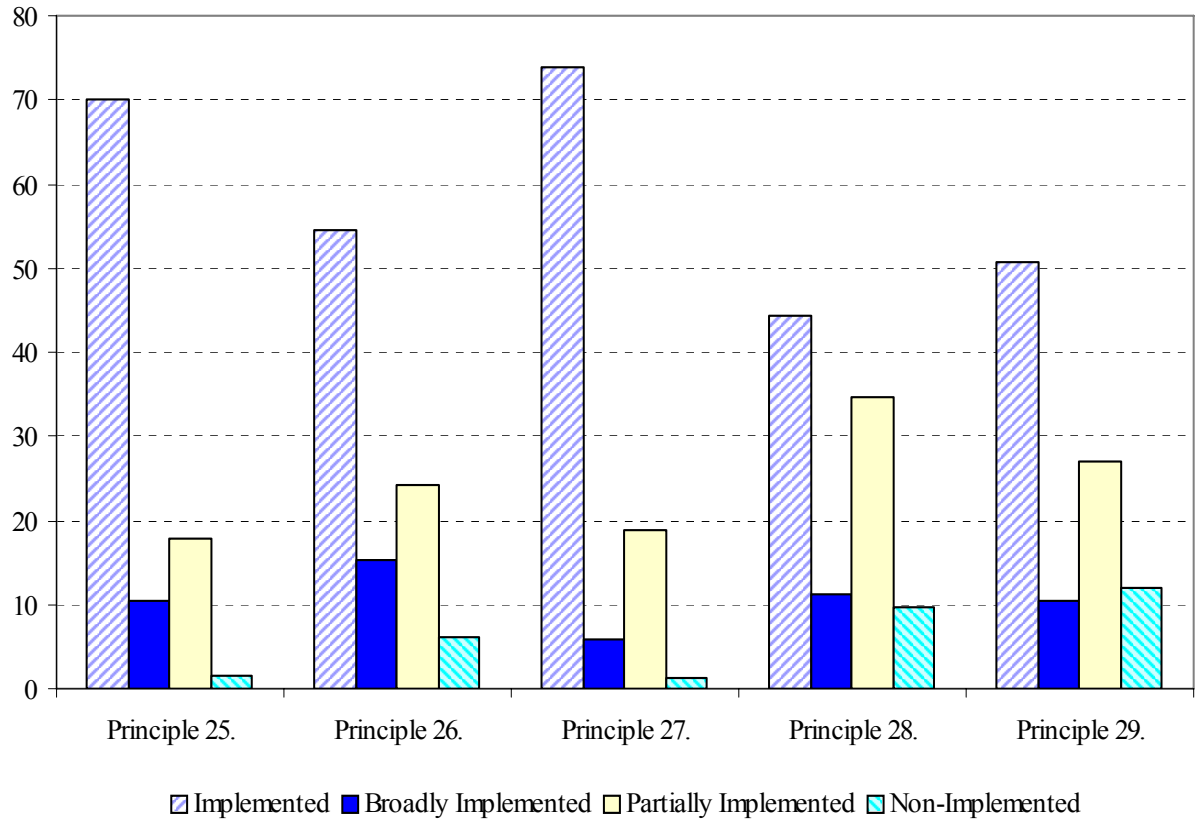
89. Assessments of Principle 23 have also resulted in a relatively high "not implemented" ratio, although the source of weakness varies. The principle was handled differently by different assessors and the results under this principle are therefore harder to summarize. Assessors pointed out some weaknesses in requirements for internal controls and risk management, although there was little comment on the effectiveness of these rules. In a number of countries, assessors noted a lack of meaningful enforcement of compliance with these rules, generally because of resource constraints. In some cases, a self-regulatory organization is responsible for regulation in this area and those market intermediaries who are not members of the self-regulatory organization are not subject to any of the requirements covered by this principle.

Addressing the failure of an intermediary

90. Many regulators have no contingency plan in the event of an intermediary's insolvency; thus Principle 24 has the highest level of non-implementation. Most assessors were willing to accept an informal plan (together with appropriate powers), but in many countries the assessor concluded that the regulator was unprepared for a financial failure, even through an informal plan. The inability to appoint a monitor or an administrator for a failing firm and the lack of authority to deal with insolvencies of firms was a weakness in a number of emerging market countries.

Regulation of Secondary Markets (Principles 25–30)

Figure 18. Principles for the Secondary Market [1]



Source: Standards and Codes Gateway (MCM).

[1] Numbers in the table represent the average percentage share of the applicable and assessed principles for all countries.

Licensing regime for market operators

91. Most jurisdictions have a licensing regime in place for stock exchanges, although it is often the case that the exchange pre-dates the regulator and so has not undergone a licensing process. The level of implementation for Principle 25 is therefore high. As indicated under Principle 7 for self-regulatory organizations generally, oversight of exchanges (measured under Principle 26) requires strengthening. Many jurisdictions do not have on-site inspections and although it is unclear whether the methodology requires this, most assessors believe it is a necessary component of adequate oversight. In other jurisdictions, inspection programs are in place but have significant weaknesses. There was a consensus among a number of assessors that a lack of real-time market monitoring at the regulator and lack of surveillance skills and resources at the regulator were obstacles to effective oversight. In a number of jurisdictions, there was a lack of sanctioning authority vis-à-vis the exchanges.

Transparency

92. Most countries meet the minimum standard for transparency (Principle 27), including equal access by all market participants to pre-trade bids and offers and immediate post-trade reporting of all trades on an exchange. However, some emerging market countries still do not have basic transparency in their markets, with ample opportunity given to intermediaries to trade off market, undermining the quality of the pricing mechanism on the exchange. There is no consensus on the appropriate level of transparency for over-the-counter markets, particularly bond markets, and in many countries these markets are quite opaque, without even a minimum requirement to report an executed trade.

Market abuse

93. Implementation of market abuse rules, as required under Principle 28, is still challenging for many jurisdictions. The unimplemented level of this Principle is relatively high. A significant number of countries had weaknesses in legislation (unlike in most other areas), but most countries were downgraded because they did not adequately enforce their rules. A lack of enforcement was generally due to a lack of authority or the lack of resources. In many countries, surveillance and enforcement of trading in unlisted shares is virtually non-existent. There was also a lack of coordination in investigations and enforcement between self-regulatory organizations and exchanges and the regulator and among self-regulatory organizations and exchanges. In some cases, assessors deemed available sanctions to be weak and therefore an inadequate deterrent.

Risk management

94. The implementation of Principle 29 is a significant challenge for many countries. Monitoring large exposures requires an understanding of market activity, and access to information that is not present at many regulators. Coordination between agencies requires

improvement in a number of countries and in some there is no aggregation of exposure data across the system. Early warning systems are not in place in some jurisdictions or require improvement.

Assessed Countries[15] Update

Completed		
Argentina	Gibraltar	Monaco
Armenia	Greece	Morocco
Australia	Guernsey	Netherlands
Austria	Hong Kong	Nigeria
The Bahamas	Hungary	New Zealand
Bahrain	Iceland	Oman
Bangladesh	India	Panama
Barbados	Ireland	Pakistan
Belgium	Isle of Man	Philippines
Bermuda	Israel	Poland
Brazil	Japan	Romania
British Virgin Islands	Jersey	Russian Federation
Bulgaria	Jordan	Senegal
Canada*	Kazakhstan	Singapore
Cayman Islands	Kenya	Slovak Republic
Chile	Korea	Slovenia
Colombia	Kuwait	South Africa
Croatia	Labuan (Malaysia)	Spain
Czech Republic	Latvia	Sri Lanka
Egypt	Liechtenstein	Sweden
Estonia	Lithuania	Switzerland
Finland	Luxembourg	Tunisia
France	Malta	Ukraine
Georgia	Mexico	United Kingdom
Germany		
Ghana		

* The Canada IOSCO Assessment was not included in the statistics since grades were not assigned. However the findings of the assessor were used as part of the input for this paper.

[15] Completion of an assessment can take some time after the end of the in-the-field mission as the reports are reviewed by the Bank and Fund and the authorities. This paper relied primarily on completed assessments but also looked at those assessments still in draft form.

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