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Plenary 1

Regulation and Supervision in the Context of a Global Financial Environment

8. Remarks by Mr. Andrew Sheng

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Panel 1: Regulation and Supervision in the Context of a Global Financial Environment

Remarks
By

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Distinguished Delegates,
Ladies & Gentlemen,

First of all, I would like to thank our hosts, Dr Dogan Cansizlar and his colleagues at the Capital Markets Board of Turkey for their warm and outstanding hospitality. Every day, we are treated to an escalating level of introduction to the richness of Turkish culture, indeed global culture, because Istanbul stands at the crossroads of Asia, Africa and Europe. I only realized this strategic importance when I visited the Grand Bazaar, which must be the mother of all global markets, since for several millennia it was the marketplace for goods from all over the world.

This morning, Minister of State Kemal Dervish said that globalization was irreversible, and Technical Committee Chairman David Brown quoted Charles Dickens in depicting the last year of global events as "the best of times and the worst of times". Ms Tipsuda, speaking on behalf of the Acting Chair of the Emerging Markets Committee, also highlighted the danger of marginalization of smaller markets, which have to deal with larger and larger global players. The theme of "Globalization: Opportunities and Challenges" reflect these contrasting aspects of global business. There are huge opportunities and benefits arising from the convergence of products, services and standards globally. However, if we do not handle globalization correctly, there will be polarization, as liquidity begets liquidity and the small become smaller.

Because of time constraints, I shall be quick and blunt on some of the polar issues that globalization poses. The events of 9.11, Enron and the accounting aftermath demonstrate clearly to me that we are witnessing the cold and ruthless logic of markets, which can be summed up as Murphy's Law: *What can go wrong will go wrong*.

Allow me to sum up very quickly how globalization affects the key market issues and participants differently – what I call the four "I's" and an R – information, investors, intermediaries, issuers and regulators.

The first "I" is Information. We all know that accurate, relevant and timely information is a market fundamental. The problems of Enron demonstrated vividly that we must move very quickly to high quality international accounting standards (IAS) and international auditing standards (IAUS). But it seems to me that what must be top of everyone's priority is a clear set of international disclosure standards (IDS) for listed companies. Without such standards, there will be plenty of information arbitrage between markets, where companies can exploit differences in disclosure requirements. Of course, the major markets are working on these issues, but I hope IOSCO will be able to push this to the top of our agenda.

The second "I" is investor. Globalization has offered the investor an unprecedented global choice of products and services. The major downside is that the investor can easily be cheated by intermediaries operating out of markets that are unregulated and outside the reach of domestic regulators.

The third "I" is intermediaries. Globalization offers the efficient intermediary global reach. Through the Internet and technology, intermediaries can span across jurisdictions and offer products and services to new customers. This has caused consolidation, alliances and mergers of intermediaries across different product or functional lines, giving rise to the emergence of huge complex financial institutions. The size, power, complexity and sometimes opacity of these institutions make the task of regulation very difficult indeed.

The fourth "I" is issuer. Again, globalization offers huge opportunities because the eligible issuer can now tap global fund raising. Of course, currently, only a few select companies are eligible for cross-border fund raising, but the trend is obvious.

In short, globalization brings huge up side to investors, intermediaries and issuers. So where is the downside? The simple answer is that the regulators essentially face the frontline downside risks.

Regulators face the toughest assignment in globalization because if anything goes wrong, we are the first to be blamed. As Murphy's Law demonstrates, things will go wrong. To cope, we now need to understand very rapidly the internet-speed of changes in technology, the markets and global issues.

But the public and we in the regulatory community must also appreciate our limitations. Allow me to dissect these constraints and issues within the context of the three key objectives of securities regulation enunciated by IOSCO:

- Protection of investors
- Ensuring fair, efficient markets and transparent markets; and
- Reduction of systemic risks.

Let us appreciate first and foremost in the protection of investors that domestic regulatory powers stop at the border. We have global markets, but local laws. We cannot protect domestic investors when they invest abroad unless we have appropriate MOUs with the relevant regulator. We cannot protect our investors on our own. To do so, we must adopt what Chairman Fernando Teixiera dos Santos said this morning, which is that regulators must co-operate very closely in order to achieve IOSCO objectives. He was also absolutely right in saying that regulators alone cannot handle many of these global issues, so that regulators must co-operate with other authorities and market participants, both domestic and cross-border, in order to resolve global issues.

This is where I must commend Michel Prada and his team, as well as the whole of IOSCO, in agreeing to adopt a landmark Multilateral Memorandum of Understanding so that regulators can work together and share information to plug some of the regulatory gaps that we all face in our work on cross-border issues.

I must confess that I see the greatest challenge in the protection of investors lies in investor education, on the need to impress on investors that whilst they are offered great opportunities in the range of global products and services, they must understand the risks, especially the counter party and legal risks they assume outside their own jurisdiction. This is an area where greater cooperation in IOSCO in investor education will pay the highest dividends.

The second IOSCO objective is to ensure fair, efficient and transparent markets. This is where all domestic regulators face two very complex and difficult issues. The first is the inherent conflict of interest between our domestic or "sovereign" obligations and global objectives. From a credit risk, product range and service quality point of view, there is no better choice for the domestic investor than for his domestic regulator to allow the top 20 global financial services providers to come in. From a globalization point of view, this may be the right way to go. But then, from a sovereign perspective, all domestic regulators have a primary obligation to protect the safety and soundness of their domestic intermediaries.

Indeed, one of the greatest concerns arising from globalization is how smaller markets and the smaller domestic intermediaries survive the competitive challenge of these global service providers, who have superior technology, superior capital and quality of service. Globalization will erode domestic franchises, and many of the inefficient domestic intermediaries will fail, with some cost to employment and domestic financial stability. This is indeed the "creative destruction" of global markets. I do not have the answers, but I can clearly see that the proper sequencing of the convergence to globalization for the markets that are not yet fully open to global market forces is the greatest challenge today for financial regulators.

The second conflict is how to maintain fair, efficient and transparent markets when there may be unregulated intermediaries operating out of unregulated and uncooperative jurisdictions. Even for regulated entities, as Ms Tipsuda has eloquently pointed out, regulators in small jurisdictions have to deal with intermediaries that are larger than their jurisdiction's GDP.

As some of us discovered during the Asian crisis, a medium-sized intermediary, such as a hedge fund, may find itself an " elephant in the pond", when it operates in a market whose liquidity shrinks in turbulent times. These elephants, whether benign or belligerent, could do considerable damage to smaller players in smaller markets, because a market where a few large players dominate liquidity is no longer a level-playing field. Nor would it be a transparent market, if the players do not have to conform to reporting requirements if they operate out of unregulated and uncooperative jurisdictions. Moreover, regulators often have no jurisdiction or full appreciation of what goes on in the unregulated OTC market.

Finally, let us address the third IOSCO objective of "reducing systemic risks". The events of 9.11 point out starkly the criticality of legal finality, operational robustness and proper contingency planning. Prior to 9.11, we were concerned with the systemic risks if one of the largest of our market participants were to fail. Post 9.11, it is horrible to imagine, but we can no longer rule out the possibility that terrorist attacks or other unimaginable events could lead to the total failure of one of the top ten or twenty global markets. This is no longer a non-zero risk.

Hence, I commend the efforts of the IOSCO Chairs' Committee, the CPSS/IOSCO task forces and the Financial Stability Forum in thinking through these immensely important but complex issues. These are issues that panels such as this one can contribute a lot to the understanding of both the opportunities and challenges that globalization has brought to our markets and our responsibilities as regulators.

Thank you.

Istanbul,
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