

IOSCO:

A key element in the restoration of financial markets confidence

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Founded in 1983, IOSCO is the international forum for coordination among the worldwide community of securities regulators. In general terms, the organization seeks to establish high standards of regulation and at the same time to promote integrity of financial markets. These are high level aims which are not always easy to meet.

Currently, the organization has 174 members. There are three levels of membership: ordinary, associate and affiliate. The first group of ordinary members contains securities regulators such as the CNMV in Spain, the AMF in France and the SEC in the USA. These ordinary members have one vote and decide on the policy of the organization. In some ways these are the most important members. Affiliate members are made up primarily of exchanges such as Bolsas Y Mercados Españoles.

Over all, the organization represents 90% of the world wide financial markets capitalization. It has four working languages including Spanish, Portuguese, English and French.

IOSCO has three specific objectives. These are:

- Protecting investors
- Ensuring that markets are fair, efficient and transparent
- Reducing systemic risk

As you can appreciate, these are ambitious objectives. Members recognize that they represent a huge challenge but they have consistently emphasized that the need to protect investors and to make sure that the markets are fair, efficient and transparent are core objectives central to the IOSCO mission.

It is interesting to compare IOSCO with other international organizations like the Basle Committee in Banking Supervision. The objectives of the Basle Committee are slightly different from the IOSCO objectives. Banking supervisors are mostly in charge of protecting the financial intermediaries, i.e. banks. They want to protect intermediaries against an excess of risk which could lead to bankruptcies. IOSCO is more involved in market efficiency and investors protection. However we all agree on the reduction of systemic risk, to make sure that the global financial system does not contain too many risks and remains stable.

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IOSCO itself has many layers of operational activity and the organization contains numerous committees, task forces, and working groups all carrying out the necessary policy work.

At the very top of the organizational structure is the Presidents Committee. It is a Committee containing the Presidents and/or Chairs of all the securities regulators. It

generally meets once a year at the IOSCO Annual Conference. It is very much the top level or political body of the organization.

Then there is an Executive Committee which acts as a kind of Executive Board to lead and drive the organization. This generally meets at least three times a year. The Executive Committee is currently chaired by Ms Jane Diplock, Chairperson of the Securities Commission of New Zealand.

There are four Regional Committees which meet to discuss specific regional problems of the members of the organization including Inter-American, Africa-Middle East, Asia-Pacific, and European Regional Committees.

Then there are two specialized working committees. The first is the Technical Committee which is made up of fifteen agencies that regulate some of the larger, more developed and international markets of the world. The CNMV of Spain is part of this Committee. The Technical Committee is currently chaired by Mr Andrew Sheng, Chairman of the Securities and Futures Commission of Hong Kong.

The second specialized body is the Emerging Markets Committee. It is much bigger having a membership of more than 70 agencies. It endeavors to promote the development and improvement of efficiency in the securities and futures markets of developing economies. The Emerging Markets Committee is currently chaired by Mr Dogan Cansizlar, Chairman of the Capital Markets Board of Turkey.

There is also a SRO Consultative Committee which has representatives from many of the exchanges around the world. It is currently chaired by Mrs Mary Shappiro, Vice Chair of the NASD in the USA.

Finally, there is a General Secretariat which is based in Madrid. It helps to coordinate the work and provide support to the organization, particularly for training, technical assistance and communication.

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The global financial system has been undergoing significant developments in recent years. The bad news was that there were several major shocks to the system including the collapse of the dot com bubble, terrorist fears, and corporate scandals. During 2003 for instance, both the NASDAQ and the Dow Jones suffered huge falls as a result of these problems.

The good news however is that the financial system was resilient enough and could with some difficulties withstand these pressures. It is fair to say that IOSCO played an important role in the resilience of the markets and in the system, by producing high level standards to make the market work better and by coordinating actions among regulators.

For the global financial system one of the significant changes that must now be taken into account has been the rise of international terrorism. The attacks of September 11 in the United States demonstrated how the global financial system needed to be prepared to respond to events.

For IOSCO these tragic events meant moving quickly in three key areas:

- Facilitating communication between regulators
- Evaluating members' experiences and contingency plans
- Adopting the IOSCO Multilateral MoU

In the first point IOSCO moved quickly to facilitate communication between regulators. When there is a crisis such as there was in this case, it is essential that people were connected so that they were aware of developments in other markets. For instance, in some cases the regulators had to close the market and in other cases they decided not to close it. In all cases however, although regulators responded to individual market circumstances, they were able to exchange as much information as possible with their fellow regulators.

Secondly, IOSCO carried out some work on evaluation of contingency planning. This meant we outlined various scenarios in order to know what would happen in different situations. For instance, what do you do if the building is destroyed or if there is no IT back-up? It was also necessary to prepare for a worst case scenario for instances where everybody in an organizational structure dies. These are all terrible scenarios but as you can see it was necessary to work on plans, compare and exchange views and experience.

The third response area I wish to discuss relates to the IOSCO Multilateral Memoranda of Understanding (MMoU). This is a key achievement for the organization.

For securities regulators, investigative work is a core component of their activities. They can investigate insider dealings, market manipulations and so on. If this investigation has a cross-boarder dimension or if there are several people from different countries involved, then it is important to exchange information among regulators. Typically in these situations, the securities regulator which is leading the investigation will need to obtain information from another country crucial to the investigation being carried out.

It seems again quite basic and obvious but for many reasons it is extremely difficult to exchange information with another country because the legal systems are often quite different from one country to another. Even in Europe, you will find differences which could be an obstacle to the exchange of information. For instance, it is often necessary to make sure that the authority, from which the information is being requested, has the legal ability to obtain information from individuals or from corporate firms. This authority has to have access to banking accounts to check the origin of a transaction for example. Once the requested authority has access to banking accounts, they have to be able to transfer this information to the requesting authority. This is sometimes a nightmare for hundreds

of lawyers when working on these kinds of questions, which seem simple but are in fact very complex.

Therefore the issue which IOSCO grappled with was how to better organize the exchange of information and how to facilitate the investigations. This is why in 2001 we created a new Task Force in order to design a special tool, a MMoU, where all signatories would commit themselves to exchange information. This work has borne fruit and we now have this MMoU, which is a unique tool to organize a network of securities regulators world wide. It is a kind of contract which is signed by regulators and commits them to the exchange of information.

The process by which a country signs onto the IOSCO MMoU is quite rigorous. In order to sign the contract the relevant jurisdiction has to comply with the rules and with the provisions of the contract. For that we have put in place a stringent screening process to check each applicant, each regulator, who wants to join the MMoU. It is an elaborated screening. As of today we have 26 signatories. It is a good number, but it is not enough especially when one considers that there are more than 100 securities regulators.

In the screening process we have another 25 in the pipeline, so all in all, really 50% of the securities regulators in the world have started or completed this screening process to join the MMoU. Ultimately it is hoped that this process will lead to a network that better facilitates corporate investigations. When fraud occurs it is necessary to act quickly. You want to get precise information, the amount, the date, names of perpetrators and so on. Clearly when regulators work together much more can be achieved. In the case of Parmalat for instance, the MMoU was used to exchange information in the course of the investigation and this proved extremely useful.

The MMoU also contains two levels of signatories, the A-list and the B-list. The A-list contains signatories who fully comply with the rules of the MMoU. The B-list is a list of regulators who commit to join the MMoU, but who are not able, legally speaking, to sign as of today. Many securities regulators of Latin America for instance, have no access to banking accounts. Where the secrecy laws are strong there can be an obstacle to join the MMoU. However the B-list enables regulators in such situations to nevertheless commit to joining the MMoU. As of today we only have four jurisdictions and we hope to have more.

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Apart from the response to the emergence of international terrorism and financial fraud, IOSCO also had to deal with several major corporate scandals such as Enron, the WorldCom, Parmalat etc....

The organization's response to these scandals and corporate failures has centered on four policy areas:

- Accounting/Auditing
- Disclosure/Transparency

- Financial Analysts
- Credit Rating Agencies

First, IOSCO issued a statement on the question of non-GAAP results. Non-GAAP results are the calculation of results which are not based on the generally accepted accounting standards. The temptation of several firms was to produce intermediary results which were not consistent and comparable over years. As a result there was a risk for investors since they receive non standardized information.

IOSCO issued a statement to draw the attention of investors and firms on the fact that there are GAAP and non-GAAP statements which are quite different. Non-GAAP statements are less reliable and the firm has to be consistent all the time if it chooses special concepts.

IOSCO also issued a statement on ongoing disclosure. The ongoing disclosure concept is very important. It was introduced in the U.S. in 2000 and it means that each time there is a significant event in the life of the firm with potential financial impact; the firm has to inform the market immediately. There should be full, timely and fair disclosure.

One of the big issues in the past years was that in several cases, CFOs knew that there was a potential significant financial impact on accounts. If a contract is lost or if projected earnings are less initially thought, then the temptation was to delay the information or disclose information to a selected group of analysts.

The changes which occurred in the US in 2000 followed a huge debate. It now means that when there is information with a potential significant impact on the accounts, it must be disclosed and the market informed immediately. IOSCO emphasizes the importance of ongoing disclosure to the principle of market transparency.

Auditor independence and auditor oversight are also important principles. It should be noted that in recent years there were instances where several audit firms were making more than 50% of revenues on the advice to clients with the result that auditing became a marginal aspect of their job. If you provide a full range of IT system advice to your clients and review the accounts as well, then obviously there is a conflict of interest because you are going to check your own work.

IOSCO has stated that in order for the principle on auditor independence to be adhered to such conflicts of interest must be eliminated and there needs to be a separation of the different services provided to the clients.

Regarding auditor oversight, it has been the situation that until now auditors were mostly self regulated. It was clear though that this was not enough and so IOSCO supported greater public oversight. The organization has stated that in each jurisdiction there should be a system of independent public oversight on the audit profession. Since then, this principle has been implemented in the U.S., in Canada, in France, and in several other

countries where there now exists a public oversight board, which is controlling the audit profession.

IOSCO also has an important role to play in relation to financial analysts. In this instance, IOSCO has issued a series of principles that sets out the necessity of avoiding conflicts of interest as well as the need to uphold the quality and integrity of the research that is produced. Our policy statement also deals with issues related to the reporting line and compensation.

For instance, we have stated clearly that the analyst must not report to the investment banking department when the investment banker is selling his own financial products. Otherwise there is a danger that the analyst would not provide an independent assessment and that the analyst would be more interested in what the investment banking department was selling in order to get more clients and more fees. The IOSCO principles set out the importance of clearly separating the roles.

There is also the important issue of credit rating agencies and the role that they place in financial markets. For investors it is important to have a good summary of financial information and understanding exactly what the information means. A credit rating agency can assist in this by providing information on the credit risk of the issuer. However, the credit rating industry has suffered from a perceived lack of transparency. In order to deal with this issue, IOSCO has produced a set of principles on what a credit rating agency should do in carrying out assessment work. To my knowledge it is the first time an organization has ever produced such statements. The guidelines that have been issued outline how a credit rating agency should fully disclose to the public the method it uses in making any assessment and to do so in a manner which is easy to understand.

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I would now like to say a few words about the Parmalat scandal that you all have heard about. As you will be aware, this was an Italian dairy group, which collapsed at the end of 2003. When it collapsed it was soon revealed that the corporate structure was very complex, based in many countries and containing unusual subsidiaries in places such as the Cayman Islands and Luxembourg where bonds were being issued on the markets.

According to public information, the group was organized in a way that enabled it to produce false financial statements. IOSCO created a task force in order to address among other issues, corporate governance, market bond transparency, use of complex structures and off shore centres.

On paper the firm seemed to be compliant with OECD Principles on Corporate Governance but in reality it was artificial since there were no truly independent committees and board members were all closely related. There were no checks and balances in the group.

I turn now to the issue of hedge funds and the increasing levels participation by retail investors in these outlets. This trend raises important regulatory issues in terms of investor protection, hence the interest of IOSCO in this area.

By way of background, hedge funds are playing an increasingly important role in financial markets. On current trends there will be more than one trillion or 1000 billion dollars of assets under management by hedge funds by the end of the year. By any measure this is a remarkable fact.

For IOSCO this trend raises some important issues. One is that that hedge funds are increasingly sold to private investors. We want to make sure that these private investors are well aware of the risks taken. It is not a question of liking or not liking hedge funds as an investment vehicle but it is important that the market is transparent and investors are aware of the level of risk with hedge funds. There is also a more systemic issue about the regulation of hedge funds. These are interesting areas that are monitored by the Financial Stability Forum.

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IOSCO is also carrying out some extremely important work in raising financial standards on a global scale. In recent years the organization has recognized the importance of this goal and we have moved to encourage jurisdictions to implement and enforce the core standards of the IOSCO Objectives and Principles.

In summary IOSCO has produced a new instrument in order to assess the detailed level of implementation of all the 30 principles in each jurisdiction. It is quite a sophisticated tool, but it is the only way to help members to improve their level of their regulation.

Among other things, IOSCO provides technical assistance through pilot programs and seminar training programs for more than 70 emerging markets which includes countries as diverse as India, China, South Africa, and Brazil. There are major emerging countries with already sophisticated markets.

As we move forward to the years ahead IOSCO will need to face the challenges of increasing financial globalization. When we discuss globalization we refer to the ways in which the financial markets are becoming increasingly linked and interdependent. If the aim is to reduce financial scandals and protect investors then as a priority it is important to strengthen banking and financial regulation.

I have been talking about standards for financial markets or financial services regulation, but banking regulation falls within the work of the Basle Committee and Banking Supervision, which is producing the so-called Basle II. I understand that you will be looking at Basle II later this week. Together with the IAIS which works on insurance regulation and IOSCO these groupings aim to strengthen and improve banking and financial regulations.

It is also important to have international cooperation and that is done with different international financial institutions such as the World Bank and the IMF as well as groups such as the G20 and the Financial Stability Forum (FSF). The FSF is an international grouping of regulators and governments that exchange views and coordinate actions. These all play a part in improving what we refer to as crisis prevention and developing contingency plans that deal with emergencies.

Throughout it all, we should not lose sight of the importance of making markets efficient and protecting investors. This is a big challenge but if high quality regulation, sound corporate governance without conflict of interest, strong enforcement of standards and transparency of information are ensured in the marketplace, then it makes the task a lot easier.

Finally I would like to mention the IOSCO annual conferences that are held every year. In 2004 this took place in Jordan and next year it will be in Sri Lanka. These conferences represent valuable opportunities for members to discuss emerging issues in world securities and futures markets as well as the policy responses necessary to deal with them.

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