

LIBA warns of threat of international over-regulation and leads ICSA call for more proportionate approach to regulation of financial markets

November 15th 2006, London: In the lead up to the IOSCO Technical Committee Conference in London, which brings together the world's leading securities regulators and the securities industry in a dialogue on the global regulatory agenda for financial markets, the International Council of Securities Associations ('ICSA') – which is composed of trade associations and self-regulatory organizations active in the world's major financial markets – has published a set of best practice guidelines for improved regulation of the world's financial markets.

The guidelines, which are targeted at the community of international financial regulators, were developed in response to the growing and unprecedented regulatory burden that is now facing international financial institutions. Called the *Principles for Better Regulation* and available at http://www.icsa.bz/html/statements_and_letters.html, the guidelines highlight the need for an approach to regulation that supports competition and consumer protection while at the same time avoiding unnecessary or excessive regulation.

The *Principles for Better Regulation* will be discussed with regulatory authorities worldwide in the coming months with the aim of encouraging and supporting a global approach to better regulation.

LIBA Chairman Alan Yarrow, Chairman of the London Investment Banking Association (LIBA) – which chaired the ICSA working group that developed these guidelines – comments:

'Over regulation of the financial sector is a real threat', he said. 'In recent years the international financial markets have undergone a plethora of new regulation which at times has seemed unstoppable. Too often regulatory initiatives have been introduced without clearly establishing evidence of a problem, or evidence that the regulation proposed is a proportionate response to a problem.'

'Well-judged regulation supports the proper functioning of markets and the appropriate protection of consumers. However, regulators need to remember that since markets are the prime source of economic success, over regulation can all too easily undermine innovation and competition.'

He added 'Many regulators are aware of the dangers of over regulation and some have, more perceptively, adopted new disciplines to make sure there are rational grounds for new regulatory proposals. The best of these make it clear that the burden of proof is on regulators to show that regulation is necessary and proportionate, and not on the industry to show that it is not. This is the approach the industry supports wherever regulation is being considered.'

The agreed principles are as follows:

PRINCIPLES FOR BETTER REGULATION

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

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

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

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

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

Even when it is determined that there is a market failure, regulatory intervention may not be the best solution. Instead, it may be far more efficient for regulators and government

authorities to encourage appropriate responses through other measures. In most contexts the range of possible measures is likely to include several of the following:

- (a) Effective monitoring and enforcement of existing regulations;
- (b) Improving the operations of the market, for example by introducing measures to stimulate competition and the provision of more information or requiring better disclosure;
- (c) Establishing an ombudsman and/or other forms of complaint procedures; compensation schemes; legal and court processes, e.g. tort actions; and providing insurance mechanisms;
- (d) Stimulating self-regulation of various kinds; and
- (e) Joint initiatives between regulatory authorities, who fix the principles and regulations, and market participants and their representatives, who can often provide the detailed guidance market participants need and which is most appropriate to market realities.

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

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

- a) **Proportionate**, and in keeping with the scale and complexity of the problem;
- b) **Targeted**, and designed to meet specific objectives, whether by sector, product, market participant or region;⁷ and,

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

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

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

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

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

A regulatory regime that is prescriptive, detailed and hard-wired from top to bottom cannot adapt easily to changing market realities. However, a regime based on stable principles can be provided with the capacity to revise operational detail quickly, and thus to track and match changing market needs and circumstances closely. To achieve the greatest contribution to efficiency and competitiveness under the principles-based approach, regulators and market participants must develop trusting and constructive relationships and the regulatory framework must be able to evolve freely to produce the concrete guidance needed at any point in time.

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

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

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

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

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

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

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

In many jurisdictions, more than one regulatory authority is responsible for regulating all or some part of the financial markets. In such circumstances, in order to avoid harming the market it is important that regulators work together to ensure that there is no conflict or duplication in their current or prospective regulatory activity. Moreover, national and

international regulators should ensure that regulatory initiatives are allocated to the appropriate national and international level recognising that some regulatory solutions are best determined and delivered at a local level so as to reflect different backgrounds and retain the benefits of diversity and constructive competition. Other regulatory areas will, of course, benefit from the provision of a “level playing field” and getting the balance right between harmonisation and diversity is important to better regulation.

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Notes:

1. The International Council of Securities Associations (‘ICSA’) is composed of trade associations and self-regulatory organizations that represent and/or regulate the overwhelming majority of the world’s equity, bond and derivatives markets. ICSA members include:

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

2. The London Investment Banking Association (‘LIBA’) is the principal trade association in the United Kingdom for firms active in the investment banking and securities industry and the Association represents the major international investment banks which base their European operations in London.