Global market, global regulation

How the world is changing for the investors' guardians

The 25th annual conference of the International Organisation of Securities Commissions was held in Sydney in May with a focus on regulation, especially in the context of the "new economy" and global markets. Following are edited extracts of presentations by regulators in two major markets —the United States and United Kingdom.

ARTHUR LEVITT, CHAIRMAN, US SECURITIES AND EXCHANGE COMMISSION.

In Asia, Europe and the United States, traditional markets, whether they are auction-based or screen-based, are increasingly under fire from new, innovative trading systems and platforms.

It could be a dealer with automatic execution and liquidity guarantees or an electronic crossing network. In both cases, the promise of disintermediation, or greater anonymity, or lower costs, is pushing traditional markets to cut costs and to become more efficient.

What strikes me most about the current environment is the salient pressure markets around the world are experiencing in the tension between competition and centrality. This tension is by no means new. But it is more pronounced today than ever before.

The question we all are wrestling with is "How do you couple vibrant competition and the innovation it produces with efficiency of centralising orders?" Put another way: "How do you ensure that a market is central enough to maximise the possibility that buyers and sellers will meet on terms that serve them best, and at the same time are competitive enough to spur enduring innovation?"

It is not good enough to have a brilliantly designed trading platform that solely produces efficient prices. There is a big difference between an efficient trading system and an efficient national market system.

I view our role at the commission as maintaining and upholding a framework that fosters vibrant systemic competition. In this framework, multiple market centres — traditional exchanges, electronic markets and dealers — compete with one another for business, spurring a race towards faster, cheaper execution of transactions.

As more countries embrace a true equity culture, and investors respond by allocating capital globally, a transparent and trustworthy global financial reporting framework has become more important than ever. Nothing erodes investor confidence more quickly than when the financial reporting process is guided by anything but fairness and integrity.

The all-too-common practice of selectively disseminating material information is a disservice to investors and undermines the fundamental principle of fairness. This practice leads to potential conflicts of interest for analysts and undermines investor confidence in our markets. In a time when instantaneous and free-flowing information is the norm, "whispered" information is an insult to the principles of free and open disclosure upon which the success of our capital markets is based.

In the United States, we are in the midst of a lively debate on the issue of selective disclosure. Some argue that stricter rules will "chill" the flow of information as companies respond by providing less disclosure altogether. I disagree. The commission's proposed rules on this issue exemplify the "best practices" standards of analyst and investor relations groups. They will provide issuers with a great degree of flexibility in the way they distribute information —including the use of new technologies over the Internet to offer extraordinarily broad access at minimal cost.

AUDITOR INDEPENDENCE

Integrity, transparency and fairness also serve as the bedrock of a strong and trustworthy financial reporting framework. Independence is at the core of the accounting and auditing profession, the very essence that gives an auditor's work its value.

But as the largest accounting firms expand their product lines, consulting and other services may shorten the distance between the auditor and management. Independence — if not in fact, then certainly in appearance — becomes more elusive.

The audit is sometimes priced lower to attract clients willing to pay for higher-margin consulting services. But the audit foothold as a distribution channel for consulting services is at the very root of the inherent tension that these interdependent relationships foster.

When performing an audit, auditors are accountable to one master — the audited company's shareholders. But when auditors engage in extensive services for an audit client truly unrelated to the audit, they must also serve another master — management. In this dual role, the auditor, who guards the integrity of the numbers, now both oversees and answers to management.

Assuming the role of "relationship" manager, the auditor helps develop and coordinate extensive cross-selling and marketing strategies with, for example, his firm's information technology consulting group. And while it may never be quite so explicit, some auditors know, and others suspect, that their compensation is influenced by how well they "manage" that relationship in its entirety. As the firms' business objectives drive them into broader alliances it becomes difficult to ascertain where one relationship ends and another begins.

In my view, any regulatory action must address a few fundamental public policy questions: Should there be more appropriate limits on the types of services that an audit firm can render to a public company client? How should audit firms be structured to assure independence? What are the consequences, if any, of public ownership? Should firms be permitted to affiliate with entities who provide services to the firms' audit clients that the firms themselves would not be allowed to provide?

We are living in a time when investors are increasingly able to shift their capital in and out of markets cheaply and easily; it may not always happen overnight, but the history of markets teaches us it can happen quickly. If investors lose faith in the integrity of a market's prices, they will go elsewhere. If investors believe that they are not receiving high quality financial information, they will go elsewhere. If they believe that their interests are being placed secondary for any reasons whatsoever, they will go elsewhere. And the road to restoring lost confidence is a long one indeed.

HOWARD DAVIES, CHAIRMAN, UK FINANCIAL SERVICES AUTHORITY.

We have seen our major markets moving up and down dramatically, sometimes by five or ten per cent in a day. In one sense, that is something which a regulator can watch with some indifference. But volatility places pressure on some of the protective mechanisms in the marketplace. Perhaps more important, it can affect the position of individual investors, particularly those trading on margin, or trading at the limit of their financial resources. These potential risks for investors worry us a lot. And they worry us particularly in London where we have seen a massive increase in the number of individual small investors accessing the exchange directly over the last few months.

Perhaps regulators are naturally more talented at identifying problems than developing imaginative solutions to them. But our regulatory reform program in the United Kingdom has given us a great opportunity to revise our system of financial regulation from scratch, and the construction of the Financial Services Authority, on quite a considerable scale in regulatory terms — over 2,000 staff and a budget of around £170 million — has given us an exciting opportunity to think in quite fundamental terms about what kind of regulator we want to be.

So what do we think regulators need to do in this new economy, to address these new challenges?

There are seven principles which I propose.

The first, which may seem counterintuitive after everything I have said about change, is that a regulator needs to stick to tried and tested objectives. In other words, the basic *raisons d'être* of regulation, market confidence and consumer protection, are not changed by new trading systems or delivery mechanisms.

If it is right, for example, that an investor should be given certain forms of information, allowed a cooling-off period, and told what the underlying costs of a transaction are when this is done on paper, then it must be right for a transaction in cyberspace, too. The regulatory delivery mechanism may change, in parallel with the change in investment delivery. But the underlying value system remains the same.

Our second guiding light is that a regulator today must be forward-looking. We must always be looking for trouble ahead. The past is another country, to coin a phrase, and we simply have to use analytical tools to think through the way in which changing economic incentives will affect the environment for investors.

And that analysis should be undertaken with an eye to our third principle, that regulation needs to be rigorously risk-based. We now benefit in London from having been given, by parliament, a set of statutory objectives which we can use to orient all our activity. We must promote market confidence. We must protect consumers of financial services, we must promote public understanding of the financial system and we must work to reduce financial crime.

There is almost an unlimited amount of work which a regulator could do in pursuit of these objectives, so we need rigorously to prioritise. And we can only do that if we have a developed risk-based approach to regulation.

And that initiative itself incorporates my fourth principle, which is that regulators must speak directly to investors. That is something which the SEC, particularly under Arthur Levitt's leadership, has been doing for some time. And we have shamelessly copied some of their initiatives. I know that ASIC, here, has done the same, and indeed we borrowed a former member of Alan Cameron's staff to help get our initiative moving in the UK. It is clear that we need to orient far more of our work towards the individual saver and investor if we are to counteract this understanding gap, this information gap, which is particularly visible in our markets today.

Our fifth principle is flexibility. The market is changing so fast that we must be ready to change with it. We cannot afford to believe that our current allocation of staff to particular tasks, or the current boundaries between regulators and exchanges, are sacrosanct. To give you one particular example, the demutualisation of exchanges, and the growing competition between them, may well affect the amount of regulation which it is right to expect an exchange to take on. In London, for example, we have reached the conclusion that one exchange, which is competing with others, should not be the national listing authority. That function transferred to us on 1 May. I have to say I feel more comfortable now with that responsibility in-house, particularly when there are considerable pressures to relax listing standards to take account of the particular circumstances of new economy stocks. My personal view is that the public-interest arguments can be better weighed by

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year. It is estimated that customers using their support Web page will save the company around $US600 million. In addition, IBM expects that purchasing supplies by the Web will eliminate five million paper invoices.

The lesson is that investing in the electronic economy should be done on a company-by-company basis. Reserve Bank of Australia deputy governor Stephen Grenville pointed out in an address that fund managers had treated the whole of Asia as one investment class rather than analysing each country and indeed each company in turn, and this had contributed to the Asian financial crisis. He noted that a sell-off of Asian equities as a whole followed the crisis, with little consideration of the fundamentals underlying each investment. This lesson needs to be applied when evaluating Internet stocks.

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less consistent hedging policies across industries. Even so, we observe some variation in hedging practices between the industrial and resource sectors, with industrial firms exhibiting more dispersion in their hedging activity than resource firms. Such differences could be attributable to firms using different risk management techniques, or also to different risk management objectives — some firms may be trying to lock in future earnings to maintain a stable dividend policy. What we are suggesting is that some inter-firm differences should also be driven by financial performance, once firms are prepared to carry some financial risks when this is in shareholders' interest. The authors are in the process of developing a model to provide such insights.

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statutory regulators in this new environment, than by a profit-seeking exchange.

My sixth and penultimate point is that regulators will need to be even more international in their outlook in the future, and will be bound to place more reliance on each other. There is no possible way, in this new environment, of hoping to police all investment activity on a host-state basis. How does one hope to impose one's own conduct of business requirements on a website based in another jurisdiction? In Europe, we will face a particular version of this problem as exchanges consolidate, and as the trading in the stocks of a particular country is increasingly undertaken outside its boundaries.

My last, seventh, point is of a slightly different character to the others. My interpretation of this new and more flexible world suggests that firms, intermediaries and investors will have far more choice about how and where they transact their business than they have had in the past. If they wish to deal through an unregulated broker, in a weakly regulated offshore centre, and buy into a wholly unregulated investment fund, for example, they are free to do so. Of course, high-net-worth individuals have always been free to do that, but that freedom will now in practice be extended to a much larger proportion of the population.

We as regulators may think that it would be highly unwise for many of these investors to manage their finances in that way — that they are exposing themselves to unreasonable levels of risk, and they will live to regret it. We may well think that, and we may well be right. But one thing we will no longer be able to do is to legislate and regulate in such a way that we impose that judgment on investors. It just will not be possible in a web-based world. J