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Governance of Securities Regulators

A Framework

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Abstract

This paper reviews the published work on the governance of regulatory authorities in order to identify the basic governance standards that apply and some of the factors that affect the implementation of good governance. There are four pillars of good regulatory governance: independence, accountability, transparency, and integrity. The regulator should be operationally independent from commercial and political influences in the exercise of its functions and powers. Accountability is the means whereby a regulatory authority is held responsible for the actions it takes. Transparency refers to the publication of relevant information designed to demonstrate consistency and openness. The fourth governance pillar, integrity, refers to the internal processes that the authority adopts to ensure there is discipline and consistency in its operations and to limit the risks of regulatory staff acting in their own self-interest as opposed to that of the authority and the market. These four elements are mutually reinforcing, in that accountability is necessary to provide legitimacy to independence, transparency is necessary to demonstrate that independence does not lead to abuse or improper behavior, and integrity is necessary to provide the discipline to control the exercise of independent powers. Available evidence suggests that independence and accountability are far from being universally applied in practice. The paper concludes with some practical suggestions that experience indicates are likely to enhance the effectiveness of the governance of securities regulators. Good governance of the securities regulator is necessary for effective regulation. It is also of importance in setting an example to encourage good corporate governance in the private sector.

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Governance of Securities Regulators: A Framework

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1. Introduction

What arrangements should a securities regulator make to promote good governance? This paper reviews the published work on the governance of regulatory authorities in order to identify the basic governance standards that apply and some of the factors that affect the implementation of good governance. The paper then includes some practical suggestions that experience indicates are likely to enhance the effectiveness of the governance of securities regulators.

The governance of regulatory authorities has received only modest attention in published research. More attention has been given to the structure of financial supervision and whether unified or sector-based supervision is more effective. The issues are linked, in that the creation of a unified regulatory authority, with substantial powers over the entire financial sector, naturally prompted a debate about the governance of such powerful institutions. Insofar as governance issues have been the subject of research, the focus has been on bank supervision rather than securities regulation. Nevertheless, the work has implications for securities regulators.

The Objectives and Principles for Securities Regulation issued by the International Organisation of Securities Commissions (IOSCO) – the IOSCO Principles – contain provisions relevant to governance and these underpin the discussion in this paper. A list of the Principles directly relevant to good governance of the regulatory authority, together with the detailed description of key issues defined in the methodology for assessing compliance, is in Appendix One. The IMF Code of Good Practice on Transparency in Monetary and Financial Policies and the OECD Principles for Corporate Governance are also highly relevant.

2. The Governing Body

Typically, but not invariably, securities regulatory authorities take the form of an autonomous agency that is established separately by statute. The governing body of the agency will often, but not invariably, be a Board or Commission which has collective responsibility for the activities of the agency. The body may consist of some combination of non-executive members (who are part-time) and executive members (who are full-time employees of the agency). In some cases the chief executive is the only executive on the Board. There may be a two tier arrangement, with a supervisory body and an executive board.

In some cases, the statute establishing the regulatory authority may allocate all of the statutory powers to the governing body. In many other cases, the statute may allocate separate responsibilities to a Board, to the chief executive or to others. There are instances where the statutory responsibilities have been allocated to a single person – a Superintendent or Commissioner, who is subject only to an advisory board.

The choice of governing arrangements must be a matter for the law and constitution of the country concerned. However, the allocation of responsibilities, the method of appointment, the procedures for dismissal of those with statutory responsibilities and other procedural arrangements will have implications for the governance of the authority. This paper discusses the implications by referring to the "Board" of the authority. The governance principles discussed in this paper apply to any of the different kinds of governing body that currently exist. The suggestions for addressing governance issues are intended to apply to different arrangements for the structure of the governing body.

3. The Importance of Good Governance

The research findings confirm that regulatory governance should be seen in the context of public sector governance. Overall, and of primary importance are preconditions for good governance, in particular, a fair and effective judicial system and sound tax and accounting principles (Das and Quintyn, 2002; and reflected in the IOSCO Principles). The absence of widespread bribery and corruption is clearly a necessary precondition for good governance.

Within the economy, good corporate governance promotes economic development (the OECD principles). Institutions in the financial sector, as owners of and creditors to the corporate sector are in a position to insist on good corporate governance and this role is likely to be more effectively preformed if the financial institutions themselves have good corporate governance. The securities regulator is in a position to enforce good corporate governance in the corporate sector and in the licensed financial institutions. There is thus a hierarchy in which good public sector governance creates the environment in which good governance of the regulator can promote good financial and corporate sector governance and hence promote economic development. Good regulatory governance is therefore necessary both to ensure good governance in the financial sector and also to act as a demonstration effect (Quintyn, 2007).

Standards for good corporate governance of public companies are set by the OECD Principles of Corporate Governance. Their overall purpose is to address the principal / agent problem: how to ensure that the managers of companies act in the interest of the company, and not in their interest or the interest of controlling shareholders. Guidelines have also been developed for state-owned enterprises, which address issues of good corporate governance in these companies, and the role of the government in setting their accountability and autonomy.

Similar issues arise with respect to the governance of regulatory authorities. The legislature has delegated its powers to the regulatory authority and it is important to ensure that they are exercised responsibly and effectively in line with the general objectives of the legislature. However, as compared with the position regarding public companies, the principal/agent problem is more complex. The regulatory authority has multiple objectives (in the case of securities regulators, typically investor protection, efficient markets and systemic stability) and multiple principals (the executive, the legislature, the regulated community, the users of financial institutions and the public). Some commentators have observed that this makes the regulatory authority more of a fiduciary than an agent – namely that it has a responsibility to act in the interests of the stakeholders but may not be directly accountable to them all (Majone, 2005).

Good governance for regulatory authorities is defined in the literature as referring to their independence, accountability, transparency and integrity (Das and Quintyn, 2002). These four elements are mutually reinforcing, in that accountability is necessary to provide legitimacy to independence; transparency is necessary to demonstrate that independence does not lead to abuse or improper behavior; and integrity is necessary to provide the discipline to control the exercise of independent powers. Each of those elements will be looked at in turn in the following section.

4. The Four Governance Pillars

Independence

The operational independence of the securities regulator is required by IOSCO Principle 2 which states that the regulator should be operationally independent from commercial and political influences in the exercise of its functions and powers.

The IOSCO Principles say that independence implies:

- A regulator that operates independently of sectoral interest; and
- The ability to undertake regulatory measures and enforcement actions without external (political or commercial) interference.

Independence is justified in the research largely by analogy with the justification for independence of central banks in the operation of monetary policy. In the case of monetary policy, short term political and financial considerations may lead to actions (for example, the relaxation of monetary conditions) that may be popular and convenient in the short term but contrary to longer term interests. Empirical evidence shows that independent agencies conduct monetary policy more effectively than governments because they adopt policies that are consistent over time, that are believed by financial markets to be likely to be consistent over time and are therefore more effective in prompting economic agents to act in a way that is sustainable over time. A government subject to short term election cycles cannot be relied upon to act consistently over time and cannot, in any case, bind its successor. An independent agency can more credibly commit itself to a consistent long term approach.

The argument in the literature suggests that the same principle applies to regulatory authorities. Some research (Das, Quintyn and Chenard, 2004 and Ponce, 2009) suggests that independent bank supervisors produce a better result in terms of the financial soundness of banks. An independent regulator may be more likely to avoid the temptation to exercise forbearance in the case of institutions which are rich and powerful and able to influence political decisions through campaign donations, superior political access or plain bribery. An independent regulatory agency may be better able to adopt consistent and credible rule-based policies and processes over time that will be believed and trusted by market participants. This trust is especially necessary in securities markets where investors must have confidence in the published disclosure documents and the effectiveness of rules banning manipulative or self-interested behaviour by those issuing securities or acting as intermediaries (Black, 2001). Only when this trust is established are investors likely to enter the market in sufficient numbers to permit capital allocation on the basis of a fairly determined market price that reasonably captures the risk/reward balance on the basis of known information.

In the case of securities regulators, there is an additional justification for independence from the government. The government is an issuer of securities in the form of government bonds and, from time to time, public assets. It frequently owns the Exchange and controls the pension funds who are important investors. It is a major market participant and any involvement in the regulatory process would create a clear conflict of interest.

Not all regulatory authorities, even those regarded as independent, are successful at resisting the temptation to bow to political and commercial influences and, indeed, Masciandaro, Pansini and Quintyn found in 2011 that authorities with good governance arrangements may have fared worse in their response to the 2007 financial crisis. However, the argument has been made that failings arose because of inadequate independence, or independence that may have been established in law but was not used effectively in practice.

Independent regulatory agencies, although not subject to a short term electoral cycle, may nevertheless be subject to improper pressures. They may be tempted to enhance their own status, power and reputation, or seek future rewards (the author is aware of cases where on-site inspectors from a regulatory authority have attempted to obtain employment from the subjects of an inspection while on-site). The close relationship between regulatory authorities and the regulated community could give rise to an assumption of communality of interest that leads to "regulatory capture". Regulatory authorities whose Board members are appointed as a reward for past political associations or who are representatives of government ministries may be willing to accept political direction. Such "political capture" may coincide with "regulatory capture" if the main financial institutions are also closely politically connected. Strengthened accountability, transparency and integrity, although valuable in their own right, also serve to support independence (Masciandaro, Quintyn and Taylor, 2010).

Accountability

Accountability is the means whereby a regulatory authority is held responsible for the actions it takes. IOSCO Principles note that accountability implies that the regulator is subject to appropriate scrutiny and review, including:

- Periodic public reporting on its performance
- A system permitting judicial review of licensing, authorizing or enforcement related final decisions of the regulator.[1]

In the context of regulatory authorities, accountability is a complex matter because of the multiple principals to whom the regulatory authority is accountable, the multiple objectives for which the authority is responsible and the difficulty in measuring the output. Hupkes, Quintyn and Taylor (2005) conclude that it is necessary to have a network of accountability mechanisms. It is vital, when constructing this network to avoid confusing accountability with control. Accountability does not mean compromising independence by giving Ministers or the market powers over the actions of the regulatory authority. The ideal result is that "No one controls the agency but it is under control" (Moe, 1987).

Good accountability mechanisms can provide legitimacy for the independence of the regulatory authority in its exercise of the coercive powers of the State (Lastra and Wood, 2009). It can enhance governance by ensuring that the management of regulatory authorities are required to justify their actions and it can improve performance by subjecting the authorities to independent scrutiny of their actions and decisions, so as to provide lessons for the future. Proper accountability also allows the market, the government and the public to have their legitimate say in the actions of the authority without subjecting it to improper and secretive control (Quintyn, 2007).

The appropriate mechanisms for accountability will depend on the legal and constitutional traditions of each country. They should start with clarity in the mandate and objectives of the regulatory authority (Hupkes, Quintyn and Taylor, 2005). Given that the powers are given by

[1] The IOSCO Principles also refer in this context to transparency, which is discussed later in this paper.

statute, there must be accountability to the legislature. There must also be accountability to the executive branch of government and to the judicial branch, in that the subjects of decisions must have the opportunity to appeal to the courts (or a specialist tribunal). Furthermore there should be accountability to the regulated community and the market. Accountability should include mechanisms for ex ante consultation, for example on rules and guidance. There must be regular reports on performance through annual reports and accountability for specific decisions.

Transparency

Transparency refers to the publication of relevant information designed to demonstrate consistency and openness. It is necessary to allow accountability to be effective (Lastra, 2004) but goes beyond that. The information must ensure that the regulated community knows what is expected of them. While this may appear self-evident, there are many examples in emerging markets where legislation or regulation on an authority's website is out of date, where guidance continues to refer to legislative requirements that have been repealed and where criteria for licensing are applied that have never been published at all.

In addition, the authority should publicize the internal processes it adopts in order to reach decisions, especially its enforcement procedures. These processes should include any consultation that takes place prior to decisions being reached – such as the publication of draft rules for comment. These mechanisms ensure that there is a proper mechanism for others to have their say about the actions of the authority in a manner whereby the public can see what opinions and pressures are being brought to bear on the authority. Transparency can deter improper influence by demonstrating where proper influence takes place (Das and Quintyn, 2004).

Transparency also includes the requirement that an authority gives reasons for its decisions and is prepared to discuss them before they are implemented. Accountability for specific decisions before an independent arbiter cannot be fair unless the subject of the decision is aware of the reasons for that decision.

Integrity

The fourth governance pillar – integrity – refers to the internal processes that the authority adopts to ensure there is discipline and consistency in its operations and to limit the risks of regulatory staff acting in their own self-interest as opposed to that of the authority and the market. The key measures are the ethical provisions in Board protocols and staff codes of conduct, the way in which the Board maintains control of the authority and satisfies itself that its policies, procedures and processes are being properly followed (Das and Quintyn, 2002).

5. The Barriers to Good Governance

There is substantial consensus on the need for good governance and, in particular, the independence of the regulatory authority. All IOSCO members have committed themselves to implement the IOSCO Principles, which include the Principles identified in Appendix One. A large number of regulators claim to have operational independence (Seelig and Novoa, 2009).

However, the evidence from assessments of the IOSCO Principles carried out as part of the financial sector assessment program suggests that independence and accountability are far from being universally applied in practice. In their 2007 assessment of the strengths and weaknesses of securities regulators, Carvajal and Elliot found that they were particularly weak on independence from the government and the political process. Quintyn, Ramirez and Taylor (2007) found that in 20 of the 32 countries they surveyed, a Minister or their representative sat on the Board of the regulatory authority, an arrangement they describe as being “diametrically opposed” to the spirit of independence. The retention of a power of direction by Ministers remains quite common – a provision in statute that, even if never formally exercised, is bound to affect the decisions of a regulatory authority which does not wish the direction power to be invoked. Many Ministers wished to retain control over the giving and withdrawal of licenses. This remained true, even in countries where there had been a recent amendment to the statutory provisions.

The extent of independence will depend on the willingness of the government to delegate regulatory decisions to an independent body. High level regulatory decisions involve trade-offs between the interests of different economic agents – such as investors or market intermediaries. They also involve trade-offs between different objectives – such as the protection of investors or the facilitation of innovation. There could be trade-offs between a desire to raise standards by imposing strict fitness and proper tests and a desire to encourage wide participation in the market to promote competition. Goodhart (in the Foreword to Masciandaro and Quintyn, 2007) points out that the resolution of conflicts between different public objectives is a function normally performed by democratic government. There may therefore be a concern that an independent but powerful body may appear to become a fourth branch of government outside the normal democratic checks and balances (Hupkes, Quintyn and Taylor, 2005).

In some countries key aspects of regulatory policy, including a final say on licenses are deliberately retained by the government, and the issue of regulatory independence in such cases is concerned primarily with supervision and enforcement. Such an approach should not be regarded as contrary to IOSCO principles, provided the IOSCO conditions (transparency, clear criteria and the scope for external review) are met.

More generally, according to Alesina and Tabellini (2004) there is a reluctance to cede control, a fear of retaining responsibility without power and a desire to continue to extract bribes. Where the government sees its role as being to favor the interests of particular groups or interests, the “grabbing hand” theory of government explains why they do not wish to give up control (Djankov et al 2001). A further issue may be the absence of sufficient trust to delegate the necessary powers. This reluctance to grant sufficient independence clearly arises from mixed motives. It is essential that the merits of good governance as a whole, including independence, should be argued from the perspective of the likely effect such independence has on the trust placed in the regulator and hence in the financial market. In particular, it is important to emphasize the way in which strong accountability, transparency and integrity arrangements can reinforce and make legitimate the independence a regulatory authority needs.

There are also barriers to the development of the other governance pillars. For example:

- The strengthening of public accountability creates an additional burden on the regulator. Widening the group of stakeholders to whom the regulator is accountable may appear to dilute the ability of the government to influence the regulator and may be unattractive to governments on those grounds. For the regulatory authority the wider the scope of accountability, the greater the scope for criticism.

- Similarly, greater transparency creates opportunities for criticism of the regulatory authority and perhaps for the government, insofar as the government takes key regulatory decisions. The need to maintain confidentiality of the affairs of intermediaries and investors may also create a barrier to full transparency.

- The detailed protocols necessary to safeguard the integrity of a regulatory authority can be burdensome and may be subject to resistance on this score.

6. The Structure and Operation of the Board

Before suggesting ways of addressing the four governance pillars, this paper now turns to the role and practical operation of the Board of a regulatory authority, since for most regulatory authorities, it is the Board of an authority that will be the guardian of independence, the main focus of accountability and which will have responsibility for key decisions that affect transparency and integrity.

The structure of the board of a regulatory authority is likely to reflect typical corporate governance structures within the jurisdiction. The post of CEO and Chairman may be combined or separate. There may be a single board including a mix of executives and non-executives or a two tier arrangement, with a supervisory board (usually consisting of part time non-executives) and a management board. All of these structures are potentially consistent with IOSCO Principles.

Examples of these different structures include the following:

- In the case of the US, the Securities and Exchange Commission (SEC) has four full-time Board members (Commissioners) and a Chairman who is also the CEO. The Board members are not executives in that they are not directly responsible for specific departments of the SEC. A number of countries in the Middle East and South America such as Saudi Arabia and Brazil have followed this model.

- The UK FSA (now the Financial Conduct Authority) governing body consists of a mixture of full-time executive members and part time independent non-executive members, with the latter in the majority. The Chairman and CEO are separate posts. Many Commonwealth countries, Crown Dependencies and Overseas Territories follow similar models, although it is frequently the case that there may be only a single executive (the CEO) on the Board and sometimes no executive members on the Board at all.

- The French AMF Board consists of 16 members who are part time and non-executive. The Chairman and CEO are separate posts.

- The German BAFIN has a two tier structure with a part time supervisory board and a full-time Executive Board. The Chairman of the Supervisory Board and the President of the Executive Board are different posts.

- The Malaysian Securities Commission has a Board with ex officio members representing other government agencies and other part time members. The Chairman is CEO and the Deputy CEO is also an executive member of the Board.

- The Securities Board of India consists of a full time Chairman, who is also the CEO, ex officio members representing other government agencies and five other members of whom at least three must be full time.

- The South African Financial Services Board has a part time board and a separate executive board. The Chairman and CEO are separate posts.

- It must be acknowledged, that not all securities regulatory authorities are governed by a board. For example, The Columbian *Superintendencia Financiera* has a rather different structure, in which the Superintendent is appointed directly by the President and Minister of Finance. The Superintendent is chief executive of the regulatory authority and there is no governing body. Once appointed, the Superintendent continues to act on behalf of the President.

Each of these structures is considered as appropriate within the context of the jurisdiction's legal traditions. The analysis in this section primarily concerns the operation of a governing board and is of relevance to all those examples described above, where a board has responsibility for the regulatory authority.

The separation of the roles of Chairman and CEO

It is argued that a combined Chairman / CEO role can enhance effectiveness by providing for a single focused leader who can drive regulatory reform. In the case of central banks, it is frequently the case that the Governor is both Chairman of the Board and CEO.

On the other hand, OECD Corporate Governance Principles suggest that when there is a single tier board, the objectivity and the independence of the Board from management are strengthened when the roles of CEO and Chairman are performed by different persons. Separation of these roles, according to the OECD Principles helps achieve a balance of power, stronger accountability and improved decision making. In the experience of some countries, a combined Chairman / CEO post has led to a lack of balance in the Board because of the extent of control by the Chairman over the Board agenda and the submission of papers by the executive, together with the inevitable knowledge advantage gained by a CEO in day to day charge of the operation of the regulatory authority.

Neither of these models could be said to be inconsistent with international best practice. OECD principles are intended primarily for the governance of corporations but the practice has increasingly been followed in regulatory authorities other than central banks.

The OECD Principles also suggests that, where the post of CEO and Chairman are combined, there is a case for a lead non-executive director to convene or chair meetings of non-executive directors. Although not discussed by the OECD, there may be a case for a lead director even if the CEO and Chairman posts are separate. The UK Corporate Governance Code states:

> *"The board should appoint one of the independent non-executive directors to be the senior independent director to provide a sounding board for the chairman and to serve as an intermediary for the other directors when necessary."*

In practice, it is likely that a Chairman and CEO would be likely to work closely together to manage the work of the regulatory authority and this is entirely natural and appropriate.

However, a close working relationship of this kind could begin to create the same danger of lack of balance within the Board as a combined Chairman/CEO post and so a lead director could help to provide for appropriate checks and balances.

Moreover, it is important that the Board should be able to learn of any concerns that the staff may have about the operation of the regulatory authority. For the most part, the views of the executive will be transmitted through the line of command to the CEO and thence to the Board. However, this is not always possible. In some instances, for a variety of reasons, the executive may not feel able to raise issues with their immediate management or with the CEO, for example if they suspected that some form of wrongdoing was involved. It would be helpful, therefore, if one Board member was designated as the Board member to whom any staff member could turn if they were concerned about an issue that they felt they could not raise with their direct management. It would be important to ensure full confidentiality protection to such "whistle-blowers".

In some of the authorities described above, where the CEO and Chairman posts are separate, the CEO is appointed by an external authority – usually the same authority that appoints the Board. In other cases, the Board itself appoints the CEO. Appointment by the President, Minister of Finance, or another external body may enhance the position of the CEO and provide for additional checks and balances with respect to the Board. On the other hand, if the Board is to be held fully accountable for the work of the regulatory authority, it should be able to choose a person whom it expects to implement its decisions most effectively. If the CEO is appointed by another authority then he or she would have a separate status and may consider there to be a mandate to implement the agenda of the person who was responsible for their appointment, rather than the Board. This could undermine the accountability of the Board. Again, there is no single right answer and jurisdictions will need to consider the position in the context of their own jurisdictions.

The role of the Board

Before considering the issues involved in executive or non-executive Board members or of full or part time Board members, it is helpful to consider the desired role of the Board.

The role of the Board of any regulatory authority might be described as follows:

- To set the overall strategy for the regulatory authority – to set policies, priorities and objectives;
- To approve secondary legislation for which the regulator is responsible and to approve proposals put forward to other authorities for secondary legislation, prosecution or other decisions where appropriate;
- To monitor the effectiveness of the strategy by receiving information sufficient to establish whether the strategy is being implemented effectively and is having the intended effect, as well as to reassess risk, strategy, policies and priorities regularly;
- To receive information that is sufficient to ensure awareness of the performance of the market for which the regulator is responsible;

- To oversee the good management of the authority and to satisfy themselves with respect to its financial management, internal controls and adherence to appropriate codes of conduct for staff;

- To challenge the performance and proposals put forward by the CEO and other executives and staff;

- To take specific decisions where required by law and also to consider any matters whose implications are significant for the achievement of the statutory objectives, including licensing and enforcement decisions;

- To hear appeals against the decisions of the executives, where these have been delegated.

Different Boards in different countries will delegate some decisions to executive staff to a lesser or greater extent depending on the nature of the authority and the market. Regardless of the extent of delegation, the legal responsibility for these matters usually remains with the Board. The question of whether executive or non-executive, full or part time Boards turns on what is the best way of ensuring the Board undertakes this role effectively in the context of a particular jurisdiction.

Executive or non-executive Board members

An executive Board member would be one that had direct line management responsibility for a department of staff of the regulatory authority, who would report directly to the Board member and for whose performance the Board member would be responsible.

In none of the regulatory authorities described above is the board of the regulatory authority exclusively made up of executive members. In some of the cases described, the Chairman is a full-time executive, where the Chairman/CEO posts are combined. In other cases, the CEO (where this is a separate position from that of Chairman) is a Board member and in some cases other executives are also members of the Board.

The advantages of a Board in which a majority are non-executive are that:

- The process of setting high level strategy, policies and practices can benefit from the presence of a wider range of people whose experience goes considerably beyond that of the day-to-day operation of the regulatory authority;

- Those who are not involved in day-to-day operations may be more easily able to see the “big picture” and view issues from a broader perspective;

- By maintaining a degree of distance from the day-to-day work of the regulatory authority, the Board is better able to provide effective monitoring of the work of the executive, to challenge its approach and assumptions, to act as an appeal against executive decisions and, in effect, to provide the first line of oversight of the authority.

- Where Board members are executives, with direct responsibility for the regulatory authority’s day–to-day operations and for line management of staff, they will inevitably have a direct reporting line to the CEO. In these circumstances, it may not always be easy for them, as Board members, to challenge proposals made by the CEO. Non-executive members, who are independent in this way, may be better able to exercise their own judgement.

These factors may explain why many regulatory bodies have at least a majority of non-executive members on the Board and in many of those cases, the entire Board consists of non-executive members.

Part time or full time Board members

Full time Boards have a number of advantages:

- It can be no bad thing to be able to rely on the full time attention of senior, highly experienced, people able to devote their full attention to the affairs of the regulatory authority;
- The likelihood that a Board member would have other interests that conflict with their role as a Board member is very much reduced if they are fully engaged in regulatory work;
- If there are matters that require urgent, Board level discussions and decision, the full time Board members are on hand and available for such discussions.

On the other hand, there are advantages in having part time Board members:

- If Board members do not have to give up all their other interests and accept the (probable) drop in remuneration involved in working full time for a regulatory authority, there may be more potential candidates and a wider pool of experience.
- Moreover, typically, boards consisting primarily of part time members tend to be a little larger, thereby expanding the expertise and experience applied to the business of the regulator.
- The use of part time Board members may also be more suited to the actual work of a regulatory board, if there are not sufficient strategic policy issues to be decided, Regulations to be adopted, high level cases to be determined or key policy issues to be resolved to demand the full time attention of board members. If there are insufficient matters for the Board to attend to at a strategic and oversight level, Board members who are full time may, by default, extend their activities into executive matters and thus interfere with the internal reporting lines of the authority.
- Part time Board members may well have a greater degree of independence, because their other activities mean that they are not so dependent on the income and position as Board members.

The disadvantages of both full time and part time boards are the reciprocal of the points made above – in particular, part time boards are likely to include people for whom conflicts of interest may arise from time to time and full time boards may, by default, stray into executive roles.

On balance, many countries appear to have judged that the balance of advantage lies with having a Board in which a majority is part-time members. The disadvantages of part time Boards can be addressed in a number of ways, for example:

- Adopting rigorous rules to avoid conflicts of interest from affecting the decisions of the Board, both by taking these into account when making appointments and by insisting on withdrawal from decisions when a conflict is material;

- Creating Committees to undertake certain functions that have the effect of reducing the burden on individual Board members and providing a means of delegating urgent decisions to a Committee where the full Board cannot quickly be brought together;

- Establishing Committees of the Board that in some cases exclude executive members and in other cases the Chairman, so as to enable the part time, non-executive members more easily to discuss their concerns and challenge the views and proposals of the Chairman and executives.

Regardless of the decision on whether Board members should be part or full time, there is a case for forming specialist Committees of the Board. It is normally appropriate to have an Audit Committee, whose Chairman would not be the Chairman of the regulatory authority. The role of such a Committee is discussed below. A Committee could be formed for the purpose of making appointments and setting remuneration of executives. The Board may appoint a Risk Management Committee to work on the risk assessment necessary for the risk based approach now followed by many regulatory authorities.

This description of current practice indicates that any of the structures described above, whether Boards consist of executives, non-executives, full or part time members may be consistent with IOSCOP and OECD principles. However, it will be important to recognize the risks created by any one model and adopt appropriate mitigation measures as described above.

Documenting the Board / Chairman relationship

International good practice suggests that in any organization it is important to clarify the appropriate relationship between a Board, its Chairman, and management. Experience in a number of regulatory authorities suggests that without such documentation, the expectations and understandings of the Chairman, Board members and staff of a regulatory authority may diverge over time and this may lead to conflict and reduced effectiveness.

The first step in preparing these documents should be to conduct a risk assessment. It is, in any case, good governance practice to make and document a risk assessment as the basis for setting priorities. In this context, however, a risk assessment would inform the Board when considering what matters to delegate and what to retain for itself, so as to ensure that highest risk factors were decided by the Board.

There is a strong case for adopting a statement of delegations which would define:

6.1.1. Matters to be retained for decision by the Board;

6.1.2. Matters to be delegated to Committees of the Board (if any are to be created);

6.1.3. Matters to be delegated to the Chairman; and

6.1.4. Matters to be delegated to the executive staff.

It should be clarified that any matter that is delegated remains the formal responsibility of the Bard and that a person with delegated powers should refer matters back to the Board where they raise issues of strategic significance, even if the issue is formally within the scope of delegated powers.

It may also be helpful to document the rights of Board members, either in a Board charter or in another way appropriate to the jurisdiction. The purpose would be to ensure that Board members are able to participate fully in the work of the Board and contribute properly to Board decisions. The Board Charter might include the following:

6.1.5. Although the Chairman will normally be responsible for calling meetings, Board members should have the right, if necessary, to insist that the Chairman should call a meeting of the Board;

6.1.6. Similarly, although the Chairman will normally set the Board agenda, Board members should have a right to add items to the agenda of any Board meeting and to insist on that matter being discussed, providing supporting documents to the Board if necessary;

6.1.7. Board members should have a right to approve the minutes of Board meetings before being signed by the Chairman;

6.1.8. The Chairman and all Board members should have the right to seek information or briefings from the executive staff, where they consider them necessary to supplement any other information they may have, and such information or briefings should be available to any Board member;

6.1.9. The Chairman and Board members should have the right to insist that any member of the senior executive team should be required to attend the Board meeting for the purpose of answering questions, or providing a report on their work;

6.1.10. The Chairman and Board members should have the right to insist that certain reports be made regularly to the Board, such as management accounts, the number of investigations and inspections, the number and nature (in summary) of complaints against the authority or the work of specific departments (perhaps by rotation), progress reports on major projects, the compliance with statutory deadlines and any other matter relating to the routine operation of the regulatory authority;

6.1.11. The Board Charter should also deal with the method of appointing the external and internal auditor, the CEO (if applicable) and other senior staff and of setting their remuneration;

6.1.12. The Board charter should also deal with the handling of any potential conflicts of interest.

The precise nature of the rights and responsibilities of Board members must be a matter for the Board to determine in the circumstances of each case.

It is noted above that this section is only of relevance to regulatory authorities that are subject to a governing board. The experience of most authorities is that a board is an essential part of the governance of an authority. Where the regulatory authority is independent of the government (as is required by IOSCO Principles) the Board is, in effect, the first line of accountability and provides checks and balances to the power of the executive of the authority. Where a regulatory authority is headed by a single executive, appointed and dismissed without constraint by a President or Minister, it is difficult to argue that such a body could be regarded as independent.

7. Applying the Governance Standards

Drawing on the research summarized above, together with the IOSCO Principles, the OECD Principles and IMF Code, it is possible to identify a number of measures that could, if adopted, enhance the governance of regulatory authorities.

It is convenient to classify these provisions according to the four pillars of governance: independence, accountability, transparency and integrity. The suggestions made below should not be regarded as seeking to extend the standards set by IOSCO but are ways in which those standards might be implemented if consistent with the legal and constitutional traditions of the countries in which regulators operate. Other ways of meeting the objectives are clearly possible and many of the suggestions could be adapted in the light of different countries' circumstances.

<u>Independence standards</u>

IOSCO Principle 2 requires that a regulator must be operationally independent from commercial and political influences. There must be a number of elements in the statute establishing the regulatory authority that give practical effect to this principle.

Most importantly, the regulatory authority must be the sole authority with responsibility for issuing licenses, monitoring compliance with regulatory requirements, enforcing the provisions and engaging in appropriate co-operation with other domestic and foreign regulatory authorities. Independence is not absolute. There must be appropriate accountability, as discussed below. Moreover, there should be an opportunity for market participants to make their views known on a range of general and specific actions of the regulator. However, beyond that, no other external body should directly influence the operation of those powers that are fully delegated to the regulatory authority.

Setting standards

In most jurisdictions, the broad principles of regulation as set out in legislation are supplemented by detailed rules or regulations. IOSCO accepts that in some jurisdictions, rules or regulatory policies may require consultation with or even approval by a government Minister. However, the IOSCO Principles stipulate that the process for undertaking that such consultation or securing that approval must be sufficiently transparent or subject to review, to safeguard its integrity.

The practice in different countries varies. For example, rules or regulations may be subject to one or more of the following processes (or different categories of rules or regulations may be subject to different procedures within the same jurisdiction). Rules or regulations may be:

- Issued by the relevant Minister (or another government authority) subject to a review by Parliament (or National Assembly) – which may be a positive vote, or the absence of a negative resolution after a defined period;
- Issued by a Minister without any external approval by Parliament;
- Issued by the Minister in consultation with the regulatory authority;
- Issued by the regulatory authority with the approval of the Minister;
- Issued by the regulatory authority in consultation with the Minister;
- Issued by the regulatory authority at its own discretion.

Where rules or regulations are issued by a Minister, and subject to a Parliamentary process, this would appear to meet the IOSCO tests of transparency and to have the safeguard of an external review. Where rules or regulations are issued by the regulatory authority at its own discretion, then the requirements of Principle 2 for independence would be met, provided that the process is established in law.

On the other hand, consultation or the securing of approval by Ministers where there is no procedure for transparency or external review would appear to fall short of the IOSCO Principle. In many jurisdictions, there is little transparency in the process in practice. Consultation with the Minister is often undertaken confidentially, in that there is no public knowledge of the extent to which rules or regulations originate in practice from the regulatory authority or the Minister and there is no scope in practice for external judicial review, except perhaps to ensure that rules or regulations are not ultra vires. It is not uncommon where rules or regulations are issued by the regulatory authority with the approval of the Minister, for the Minister to amend draft rules or regulations submitted by the regulatory authority without giving reasons – even to the regulatory authority, leaving the regulatory authority to explain or defend rules or regulations which it has not approved and with which it may not agree.

The practice in each jurisdiction must follow its legal and constitutional traditions and the independence requirement can be met in different ways. However, it may be difficult to see how the IOSCO Principle 2 can be regarded as met unless:

- The regulatory authority has the opportunity to comment on rules and regulations before they are promulgated;

- The process of consultation between Minister and regulatory authority should be transparent as required by the IOSCO principle, which could be achieved by ensuring that draft regulations submitted by the regulatory authority to the Minister) or the views expressed by the regulatory authority on a draft published by a Minister) should be published and the Minister be required to explain and be accountable for decisions made – particularly where the Minister overrules the regulatory authority.

In many countries, it may be unrealistic to expect the process of consultation to be as transparent as implied by the above suggested practices. However, unless a transparent process of some kind is followed or there is the scope for external review of these regulations, the practice would appear to fall short of the required IOSCO standard.

The Composition of the Board

The composition and terms of appointment of a Board are critical factors. The composition of the Board will have an impact on its ability to demonstrate independence from political and commercial influences. The key issues are the presence, on the Board of government officials, officials from other government agencies, representatives of commercial or professional associations and market participants. These are discussed, in turn, below.

Although the presence of a Minister on the Board of an authority is unusual, it is not uncommon for representatives of the Minister of Finance to be ex officio Board members. Defenders of this practice assert that they have never seen such an official put forward the Minister's views.

Such assertions misunderstand the nature of a civil servant's role. An official of a Ministry of Finance is responsible to and acts on the instructions of a Minister. If there are no specific instructions the official is bound to act in accordance with his or her best understanding of the approach the Minister would be likely to take. A Ministry official on the Board is effectively representing the Minister's interests on the Board and is thus exercising influence or interference in the Board's decisions.

It is also sometimes argued that a Ministerial representative is but one member of a larger Board and hence the scope for interference is limited – especially by a strong and robust Board. In some cases, this could be true. However, where a Ministerial representative is on the Board, it will be difficult for market participants to know whether or not the representative is exercising a dominant influence and so there would remain a suspicion of undue government influence.

Taking all of these factors, it is hard to reconcile the presence of a Minister or a Minister's representative on the board of a governing body with the IOSCO principle that the body should be free of political interference.

The position with respect to representatives of other public agencies is somewhat different. It is not unusual, for example, for the Governor of the Central Bank (or a representative), of the Company Registry or other regulatory authorities, to be members of the Board of a securities regulatory authority. Where those agencies are, themselves, independent of the government, their appointment on the Board of the securities regulatory authority would not seem to compromise its independence from improper political or commercial influence.

Appointments of representatives of public agencies are often justified on the grounds that they enhance coordination between the agencies. In practice coordination is more likely to take the form of practical day to day interactions between staff at working level. Moreover, the argument based on coordination would also imply that the ex officio Board appointments should be reciprocal, with representatives of the securities regulator also being appointed to the Board of the Central Bank and other agencies (and in practice, this is much less common). Nevertheless, there is clearly merit in the argument that interlinking Board membership between complementary independent agencies can be an advantage in encouraging better coordination and cooperation between authorities.

On the other hand, such ex officio memberships can create difficulties of their own. There are frequently differences of opinion and approach, from time to time, between different public authorities. These differences may well arise from their different approaches and priorities.

Where the chief executive (for example) of one authority is on the Board of another, the position could be difficult when the interests of the two authorities diverge as there would be a conflict of loyalties. It is important that appropriate protocols be adopted to deal with such situations before they arise. Provided that this is done, the appointment of ex officio Board appointments of this kind need not compromise independence.

A particular issue arises with the respect to the government's law officers. Some jurisdictions appoint a representative of the Attorney General (or equivalent position) to the Board of the securities regulator. This can have practical advantages in terms of legal advice and expertise with respect to the drafting of regulations or laws. It may also assist in the coordination of the enforcement function. However, where the Attorney General is a member of the cabinet and is a political appointment, then independence from political influence could be called into question. Moreover, where the Attorney General has a duty to make an independent assessment of the public interest in prosecuting individuals accused of securities-related offences, there may be some difficulty if the Attorney General was also a member of the Board of the securities authority that carried out the investigation. Circumstances alter cases and the effect of the Attorney General or a representative on the Board on the independence of the securities regulator will depend on the specific circumstances.

Market expertise on the Board of a securities regulator is clearly an important advantage. This is sometimes achieved by appointing representatives of professional or industry associations to the Board and sometimes by appointing individuals who have personal market expertise, even though they may not be representatives of any market participant or association.

Where professional or commercial associations (the brokers association, or the accountants' association for example) have the right to nominate a Board member, this may be statutory or by convention. Moreover, the right may be to nominate a person for consideration, or the right to expect that a person nominated by the association would, in the event be appointed. IOSCO Principle 2 refers explicitly to independence from political and commercial interference and it is difficult to reconcile this with the presence on the Board of representatives of professional or commercial associations.

If representatives of professional or commercial associations are appointed to the Board, and if the nominee of the professional association is a currently active market participant, conflicts of interest can easily arise as discussed below. Even if the nominee is not an active participant in the securities market, the position of the Board member, nominated by a professional association, could lead to ambiguities about the primary loyalty of that nominee, in the event of a disagreement between the securities regulatory authority and the professional association – as is likely to occur from time to time. As with the case of ex official members from government agencies, it will be important to ensure that Board protocols identify the problem and the way it should be dealt with – a point discussed further in the context of integrity.

Board members who are currently active market participants or directors of listed companies on the Board could add expertise and market knowledge. In principle, Board members who are market participants could withdraw if any matter affecting their own interests was discussed. However, in practice, many decisions taken by the Board will affect the interest of a current market participant. Any enforcement action against a competitor or any other market participant would affect those interests. Decisions with respect to rules or guidance could in practice favor or disfavor individual market participants and the presence of a current market participant or listed company on the Board could be seen as improper influence. It is appropriate that market participants should be able to comment on rules and guidance but this should be done in a transparent way as discussed below, and not through the presence of individual market participants on the Board. It is acknowledged that, in small countries with a limited pool of expertise, it may be necessary to accept some currently active market participants on the board of a regulatory authority in order to achieve the necessary degree of knowledge experience and expertise. Nevertheless, it is, for the most part, difficult to reconcile the presence of active market participants on the Board with the principle of operational independence from commercial influence.

Market expertise is valuable but restricting Board membership to those who are not currently active is safer. Even in this case, however, continuing links with active market participants may create conflicts of interest which should be dealt with through appropriate protocols or Codes of Conduct, training programs, etc.

In summary, the composition of a board is bound to be affected by the legal and constitutional traditions as well as the scope and authority of the Board (which is discussed further below). The conclusion of the analysis above cannot be definitive for all cases and different circumstances may, in exceptional cases, justify a different outcome. Nevertheless, the general conclusion is that:

- It is difficult to reconcile the independence principles with the presence, on the Board of current Ministers or their representatives, or of active market participants or their representatives;

- The presence of representatives from other independent public agencies can add value without compromising independence but may create conflicts of interest which should be resolved through appropriate codes of conduct on conflicts of interest as noted above;

- Similarly, the presence of others with market knowledge, but who are not currently active market participants can add value without compromising independence but also create conflicts of interest that should be resolved in the same way.

Appointment and Dismissal of Board members

It is important that Board members should be appointed on the basis of professional skills and experience and that there should be continuity within Board membership to allow a collective spirit of independence to be engendered. However, in many emerging markets the Minister appoints political associates and the Board members are all required to resign when a government changes after an election, or have such short terms that a new government is able to replace them within a short period. A Board is unlikely to act independently in these circumstances.

In order to limit the extent to which Board members are appointed as a political favor and expected to resign when the color of governments change, IOSCO Principles stipulate that the ability of the Minister to dismiss the Board members should be constrained by law to factors that clearly prevent the member from performing his or her role.

In addition, some countries have put further safeguards in place. While they may not be possible in all countries, the following suggestions are worthy of consideration:

- The appointment of Board members should be staggered so that they do not all become due for reappointment (or retirement) at the same time, thus permitting continuity and permitting the Board to build up internal cohesion that can reinforce independence;

- The terms of appointment should be reasonably long – at least three years and preferably more;

- The appointment process could include the public advertising of the position, the involvement of an independent agency to interview candidates and create a short list and a constraint on the Minister to accept a candidate on the short list or instruct the nominating agency to start again (and the process, which need not be in the statute, should be documented and published);

- Consideration could be given to engaging a Board member from outside the jurisdiction to add an international slant and add further independence (especially in smaller markets, where the pool of domestic expertise may be limited).

Legal immunity

The Board and staff of the regulatory authority should have legal immunity from civil proceedings in respect of decisions taken in good faith. This immunity, which is required by IOSCO principles, should continue to apply after the departure from membership or employment and should be backed by a guarantee that the cost of defending any case brought against an official or Board member would be met by the authority.

Budgetary matters

The independence of a regulatory authority could be compromised if it fears that any decision contrary to the Minister's wishes might be met by reductions in budget or remuneration. A large number of authorities continue to depend on government subventions (45% in the sample selected by Seelig and Novoa (2009)). When the government funds the regulatory authority, it is reasonable that it should be able to control the amount it is prepared to pay and to be able to cut the budget when there is a fiscal emergency. However, in some countries it is common practice for the government to engage in annual negotiations which extend well beyond the start of the financial year covered by the funding allocation and to restrict reallocations of expenditure within budgets during the year, as if the regulatory authority were simply another government department. Such practices are clearly inconsistent with the IOSCO requirement for a stable and sufficient source of funding.

Where the regulatory authority is funded entirely from fees, there may be less difficulty in ensuring budgetary independence. However, even in this case, there are some countries where the budget must be approved by the Minister of Finance. This is a matter for each country to determine in the light of its fiscal and constitutional traditions. However, from the point of view of independence, it is clearly preferable for the budget to be unconstrained by external control, provided that the regulatory authority is accountable for the use of resources.

One way of reconciling the need for budgetary stability with the government's proper desire to control its budget is for government publicly to set a budget for the authority a reasonable period ahead – for example three years – and to commit itself to maintaining that budget unless exceptional circumstances force a reconsideration. If the budget were set in the light of an independent assessment of what resources were required to meet the IOSCO Principles, then the position would be stronger.

It is sometimes the case that a fully independent regulatory authority that is nevertheless dependent on government funding, may find that its very independence means that it does not have a champion within the government to seek adequate resources. This is a phenomenon that should be taken into account when determining the budgetary process.

An opposite problem that confronts some regulatory authorities is that they collect more revenue than is necessary for their operation. This position can occur for example, where the securities regulator is also the company registrar (and registration fees are more than is necessary to administer the Registry). It may be the case in some countries that license fees amount to a form of tax. Where this surplus has to be returned to the government as part of an annual budget negotiation, the annual negotiation in effect sets the budget for the regulator and can result in the budgetary independence of the securities regulatory authority being undermined.

Any government clearly has the right to collect taxes from companies or from license holders if it so chooses. However, where the revenue collected by the regulatory authority is, in part, passed to the government, there is a risk that accountability is blurred. It would seem reasonable to distinguish between revenues that are taxes and those that are regulatory fees. The regulatory fees should be sufficient to enable the securities regulator to function. The securities regulator should be accountable to the public for those fees. Any further charges made are, in effect, taxes and, for these, the government should be accountable. The principles of independence, transparency and accountability are all involved in such a case and would point to a clear distinction being necessary between regulatory fees and additional taxes.

Without appropriate checks and balances, a regulatory authority may not be sufficiently economical in the use of resources and may impose too great a burden on the regulatory community by way of excessive fees, or by absorbing too high a proportion of the available skilled staff. This problem need not be overcome by insisting on government control of the regulatory authority's budget but by appropriate accountability arrangements, as described below.

Linked to the question of budgetary funding is the remuneration of regulatory officials. Although it is common practice for central bank staff to be paid salaries that are competitive with those in the financial markets, it is also common in emerging markets for securities regulators to pay their staff according to salary scales derived from the government. While this is understandable when the government is funding the budget, the effect is that such regulators find it very difficult to recruit and retain skilled staff. There is considerable advantage in being able to recruit staff with market experience and this is unlikely to be possible where remuneration is very substantially below market levels. It is important, therefore, for the exercise of reasonable independence that the regulatory authority should be able to pay the salaries it considers appropriate and to make its own judgment of the balance between pay and staff numbers within a defined budget.

Enforcement

IOSCO Principle 11 makes clear that enforcement powers may be exercised by the regulatory authority, or some other competent authority. The Principles do not discuss the nature of the appropriate relationship between the regulatory authority and any other competent authority in the context of independence and accountability. Principle 12 states that the regulatory authority should be able to discipline or sanction regulated entities where they file to supervise their employees but does not otherwise insist that sanctions powers should be given to the regulatory authority.

The exercise of enforcement powers must be consistent with a jurisdiction's legal and constitutional traditions. Where a regulator has enforcement powers, it should be able to exercise these powers independently, since this must be regarded as being within the definition of operational matters. It would be expected that a regulatory authority should have the capacity to impose administrative sanctions on regulated entities without having to consult another authority and without being subject to political or commercial interference.

Where it is envisaged that a criminal sanction may be imposed, it is frequently the case that the responsibility for determining if such a sanction should be imposed and the imposition of such a sanction is within the responsibility of another authority such as a public prosecutor. It can be highly frustrating for a regulatory authority if the public prosecutor declines to pursue a criminal sanction. Nevertheless, in many countries (including civil and common law jurisdictions) the prosecutor has independence in making decisions on prosecution and it will not always be possible for a regulatory authority to be able to insist either that a prosecution takes place, or on being kept informed of progress. This position should not be regarded as compromising independence.

De facto and de jure independence

The analysis above focuses on the legal and other practical arrangements that may be in place to protect the independence of the regulatory authority. The degree of independence actually exercised by the regulatory authority may, however, differ from that implied by the statutory and other arrangements.

In particular, a regulatory authority may fail to assert its independence by deferring to the opinions of political or commercial representatives, even though there is no statutory reason to do so. In one instance, the Board of a regulatory authority left the position of chief executive open for several months because it was reluctant to make a nomination (which was its statutory duty) before being given guidance from the Minister of Finance as to which nomination to make. Where there is government subvention, there may be informal pressures from the government with the implied threat that funding could be cut if the authority does not comply with government wishes. Close connections between the market participants and politicians can also result in de facto commercial influence through a variety of mechanisms that is not provided for in statute.

On the other hand, it is possible for a regulatory authority to stretch the boundaries of independence by robustly asserting its own views. In effect, this would be challenging the government or commercial influences to seek to restrain it. However, it is less likely that a regulatory authority will be able to assert independence in the absence of appropriate statutory provisions. Where a Minister has a statutory right to give a direction, or to overrule a licensing decision, for example, it is likely to affect the regulator's decisions, even if the statutory right is not exercised. The regulator will know that the right could be exercised and is more likely to modify its own decision in order to avoid prompting a direction or overrule by the Minister.

Appropriate statutory and other provisions, in line with IOSCO Principles, should be regarded as a necessary but not sufficient condition for de facto independence. A number of commentators have observed that de jure independence does not necessarily result in de facto independence. A regulatory authority has to have the strength of purpose and will to assert independence in order to make it effective (Palmer and Cerutti, 2009).

Accountability standards

IOSCO Principle 2 also requires accountability. As noted in the literature reviewed above, it is necessary to provide multiple accountability mechanisms. The securities regulatory authority should be accountable to the three branches of government (legislature, executive and judiciary) and should include both ex ante consultation and performance standard setting and ex post explanation and review.

Ex ante consultation and performance standards

It is clearly essential that the mandate and objectives of the regulatory authority should be clearly stated in the legislation. In addition, it is appropriate for the authority to have objectives for the short to medium term. The objectives could be set by the authority itself, or by the government, or negotiated between the government and the Board of the authority. It is important that objectives set by the government should not compromise independence. These objectives could also be subject to consultation with the market participants. Once set, they can be a measure against which the authority can be held accountable.

In addition, the authority should be required to consult all stakeholders prior to the promulgation of regulations, rules or guidance. This consultation can take a variety of forms, including workshops, but must provide sufficient time for the market to consider and comment on the proposals. In the case of important changes to regulatory standards, there should be an opportunity, prior to any consideration of drafts, for a discussion of the policy objectives to be achieved by the reforms, preferably on the basis of a published discussion paper. In all cases, draft regulations, rules or guidance should be published to allow an opportunity to comment. Drafts should also include an assessment of their impact and cost. Once comments have been received, it is important for the authority to demonstrate that it has received, understood and considered the comments. One effective way of achieving this is to issue a response to the comments (if necessary, the comments can be aggregated in the formal response).

Ex post explanation of performance

The publication of audited financial accounts of the regulatory authority is common practice. In addition, many authorities include a report of their performance. Such a report could include:

- A report on performance in respect of the objectives set for the authority;
- An update on any new regulations, rules or guidance issued;
- A description of the implications of enforcement decisions for market practice (respecting confidentiality);

- An account of instances of international co-operation (where permitted by the counterparties);

- A description of the internal processes adopted by the authority (including meetings of the Board and Committees and any protocols adopted).

The authority should be prepared to be questioned publicly on its performance. Where it is consistent with constitutional practice, the Chairman and CEO should be available for questioning by the Parliament (preferably a Committee). There may be ad hoc enquiries by the Parliament and this is also a useful accountability mechanism. Meetings with the public, investors, or market participants are additional mechanisms for providing accountability.

It is noted above that, in order to prevent abuse, there should be checks and balances in order to ensure the regulatory authority does not consume excessive resources. The authority should therefore be prepared to be held to account by the executive branch of government and license holders who pay fees. It could offer presentations and submit itself for questioning about its performance in respect of its budget or objectives. Some countries give the executive the power to commission ad hoc enquiries into the performance of the authority (for example, into the efficiency or effectiveness of its operations in general or in specific areas).

There is a case for creating a unit of the executive branch whose function is to oversee the accountability of various agencies. Its role could be to be ensure that all the formal elements of accountability are performed appropriately - such as the timely submission of reports and the adoption of proper protocols for consultation. The unit might be responsible for setting objectives for the agency. The unit could also engage in dialogue with the agency about its performance and report back to the executive branch of government on its findings. A securities regulatory authority may well be subject to this form of accountability. Such an arrangement can ensure that accountability is effective. The creation of the unit as a buffer between the regulator and the government can help ensure that there is no breach of independence. It is important that the unit should not itself act in a way that undermines independence and it should be subject to appropriate confidentiality obligations.

Review of regulatory decisions

It is clear from IOSCO Principle 2 that a person affected directly by a specific regulatory decision should be entitled to have a hearing by the authority prior to the decision being taken and to an external review by the courts or, if it exists, a specialist tribunal. These are two separate processes that apply to decisions such as license applications, imposition of license conditions, directions, or administrative sanctions. For these hearings or appeals to be fair, the authority should be required to give reasons for its decisions.

There will be circumstances where the authority has to act quickly and the law should provide that, where this is the case, the authority can act first and permit the hearing and appeal after the decision is implemented.

Those who are subject to decisions of the authority that are overturned on appeal should be able to claim compensation, although this must not amount to the creation of personal liability for actions taken in good faith by authority staff.

The nature of the appeal process must depend on the legal and constitutional practices of the country. A number of regulatory authorities have established procedures whereby the initial decision (licensing, conditions, sanctions etc.) are taken at an administrative level, below that of the Board, or sometimes by an independent body. This has the result that, in the event of the subject of the decision seeking a hearing by the Board of the regulatory authority, the Board would not have been involved in the initial decision and can be regarded as more independent in its consideration of the representations it hears. This is consistent with Principle 3 on procedural fairness. However, this internal appeal process is not an adequate substitute for an external review of decisions by the Board, since IOSCO principles stipulate that there should both be an opportunity to be heard and the right to external review.

It is preferable for the independent arbitrator (whether a court or tribunal) to be able to review a case on its merits (not simply to judge whether proper processes have been followed) and, where it is considered appropriate, to set aside the decision of the authority.

<u>Transparency Standards</u>

IOSCO does not have a single transparency principle, although the requirement in Principle 4 to adopt clear and consistent processes is of direct relevance to transparency, since it is the intention of IOSCO that such processes should be published. Moreover, the IOSCO compliance methodology states that consultation processes with the government should be transparent and that the authorities' regulatory processes should also be transparent. The IOSCO Principle on independence and accountability also emphasizes the importance of transparency.

The first essential is that the relevant legislation, regulations and guidance should be available to the public – preferably on the website of the authority.

In addition, the authority should publish the forms that are necessary to make any applications and the processes that will be adopted to deal with those applications. Other processes, particularly the enforcement procedures, should also be published together with a description of how the process will respect the rights of the subject of enforcement action and, more generally, how the process will operate.

Where the authority adopts policies that will govern its approach to interpreting the legislation, regulations, rules or guidance, then these policies should be published. There should also be discussions for key areas of policy, with interested parties.

Internal processes, such as Board protocols to deal with potential conflicts of interest, the appointment procedure for the Board members and other procedures that will demonstrate how the authority uses its powers, should preferably also be published in order to achieve full transparency. Some authorities also publish their staff manual and code of ethics and this should be considered.

The suggestions made in paragraph 0 above are also relevant to transparency.

<u>Integrity standards</u>

IOSCO Principle 5 requires the Board and staff of a regulator to observe the highest standards of integrity, including the protection of confidentiality. In addition to the specific issues relating to conflicts of interest and the protection of confidentiality, the compliance methodology also refers to procedural fairness.

It is essential that the Board should adopt and preferably publish its protocol for dealing with conflicts of interest. Requirements for staff should be documented in a staff code of ethics or staff manual. It will often be necessary to have different procedures for the Board and staff, as their circumstances will be different – especially if some or all of the Board members are part time with other active interests. As noted above, the protocol should also deal with the treatment of differences between the Board and other organizations or agencies which are represented on the Board. The protocol and staff ethics code should normally include the following provisions:

- A definition of what may be regarded as giving rise to a conflict of interest and a means of making a determination where the position is unclear;
- A disclosure regime to enable the Board and staff to be aware of potential conflicts of interest;
- Requirements that are placed on the Board or staff where certain kinds of conflict situation arise, such as provisions for withdrawing from discussions in the Board, and disclosing or seeking permission for dealings in securities;
- "Whistle blowing" arrangements to provide a mechanism for staff who are concerned about wrong doing but who cannot raise the issue through the normal management line.

The protection of confidentiality will normally be included in the statute establishing the authority. This has to be sufficiently restrictive to ensure that the regulated community and foreign regulatory authorities have confidence that information that has been provided will be protected while allowing gateways for appropriate disclosures. Many countries have provisions on the following lines:

All information should be kept confidential unless:

- it is public already;
- the information is published in aggregate form so that specific details relating to individuals cannot be determined;
- disclosure is with the consent of the person about whom the information relates and the owner of the information;
- disclosure is required or permitted by law or ordered by a court;
- the authority considers that disclosure should be made to another authority to enable it to meet its responsibilities.

When considering whether or not to make a disclosure to another authority (including a foreign regulatory authority), the authority should take account of:

- any commitments it may have made to the person providing that information;
- whether the recipient is prepared to pay for the cost of assembling the information;
- whether the recipient will give appropriate confidentiality protection to the information.

The staff code of ethics and Board protocol should also ensure that appropriate procedures are followed so that information is protected and only appropriate and lawful disclosures are made.

However, the integrity of the authority's operations is a topic that goes considerably beyond the question of conflicts of interest and the preservation of confidential information. It is important that the Board adopts and documents the policies it considers appropriate for the operation of the authority, in the light of the Board's assessment (also documented) of the risks it faces in meeting the authority's objectives. Once these policies are determined, the Board will need to set the internal processes it considers necessary to ensure that its policies are followed. In the latter context, the observations made above with respect to the adoption of a Board Charter and statement of delegations is relevant. In addition, a Board should consider the extent to which it should:

- Describe the operational processes of the Board itself, its meetings, the reporting arrangements for Committees and the executive, the taking and circulation of minutes, the role of the Chairman and the mechanism for appraising the performance of Board members;

- Adopt an organization chart with job descriptions for all senior posts, and preferably all posts, that define not only the duties but also the areas of discretion and reporting lines;

- Ensure that a staff manual that describes the operational procedures is prepared and distributed to staff and that staff are given appropriate training in their duties;

- Define the information that should be presented to the Board to enable the members to satisfy themselves that its policies and procedures are being followed;

- Arrange for regular (normally annual) reassessments of the processes and controls to ensure that they continue to be appropriate.

It is already noted above that the enforcement procedures should be documented and preferably published. In addition, the staff manual should identify the procedures necessary to ensure consistency in the processes of the authority.

8. Concluding Remarks

Good governance of the securities regulator is necessary for effective regulation. It is also of importance in setting an example to encourage good corporate governance in the private sector.

The practical examples given in this paper are intended to be suggestions that could help in encouraging good governance and meeting the international standards but should be considered in the light of the particular circumstances of different countries.

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Appendix One: IOSCO Principles on Governance

Principle 1: The responsibilities of the Regulator should be clear and objectively stated

Key Issues

1. Responsibilities of the Regulator should be clear and objectively set out, preferably by law.

2. Legislation should be designed to ensure that any division of responsibility among regulators avoids gaps or inequities. Where there is a division of regulatory responsibilities, substantially the same type of conduct and product generally should be subject to consistent regulatory requirements.

3. Thereshould be effective cooperation among responsible authorities, through appropriate channels.

Principle 2: The Regulator should be operationally independent and accountable in the exercise of its powers and functions

Key Issues

Independence

1. The regulator should be operationally independent from external political interference and from commercial, or other sectoral interests, in the exercise of its functions and powers.

2. Consultation with or approval by a government minister or other authority should not include operational decisions.

3. In jurisdictions where particular matters of regulatory policy require consultation with, or even approval by, a government minister or other authority, the circumstances in which such consultation or approval is required or permitted shouldbe clear and the process of consultation and criteria for action sufficiently transparent or subject to review to safeguard its integrity.

4. The regulator should have a stable source of funding sufficient to exercise its powers and responsibilities.

5. There should be adequate legal protection for regulators and their staff acting in the bona fide discharge of their functions and powers.

Accountability

6. The regulator should be publicly accountable in the use of its powers and resources to ensure that the regulator maintains its integrity and credibility.

7. There should be a system permitting judicial review of final decisions of the regulator.

8. Where accountability is through the government or some other external agency, the confidential and commercially sensitive nature of information in the possession of the

regulator must be respected. Safeguards should be in place to protect such information from inappropriate use or disclosure.

Principle 3: The Regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.

1. The regulator should have powers of licensing, supervision, inspection, investigation and enforcement.

2. The regulator should have adequate funding to exercise its powers and responsibilities.

3. The level of resources should recognize the difficulty of attracting and retaining experienced staff.

4. The regulator should ensure that its staff receives adequate, ongoing training.

5. The regulator should have policies and governance practices in place to perform its mandate adequately.

6. Regulators should play an active role in promoting the education of investors and other market participants.

Principle 4: The Regulator should adopt clear and consistent regulatory processes

1. In exercising its powers and discharging its functions, the regulator should adopt processes which are:

(a) Consistently applied.

(b) Comprehensible.

(c) Transparent to the public.

(d) Fair and equitable.

2. In the formulation of policy, subject to enforcement and surveillance concerns,33 the regulator should:

(a) Have a process for consultation with the public, including those who may be affected by the policy.

(b) Publicly disclose its policies in important operational areas.

(c) Have regard to the cost of compliance with regulation.

3. The regulator should observe standards of procedural fairness.

Transparency and Confidentiality

4. Transparency practices, such as publication of reports on the outcome of investigations or inquiries, where permitted, should be consistent with the rights of an individual to a fair hearing and the protection of personal data, factors that will often preclude publicity when a matter is still the subject of investigation.

Principle 5: The staff of the Regulator should observe the highest professional standards including appropriate standards of confidentiality

Key Issues

1. The staff of the regulator should observe the highest professional standards and be given clear guidance on matters of conduct including:

(a) The avoidance of conflicts of interest(including the conditions under which staff may trade in securities).

(b) The appropriate use of information obtained in the course of the exercise of powers and the discharge of duties.

(c) The proper observance of confidentiality and secrecy provisions and theprotection of personal data.

(d) The observance of procedural fairness.

2. Failure to meet standards of professional integrity should be subject to sanctions.