

**METHODOLOGY FOR ASSESSING IMPLEMENTATION OF THE IOSCO
OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION**



OICU-IOSCO

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METHODOLOGY FOR ASSESSING IMPLEMENTATION OF THE IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION

I. INTRODUCTION

This Methodology is intended to provide guidance on the conduct of a self-assessment or third party assessment of the level of implementation of the International Organization of Securities Commission's *Objectives and Principles of Securities Regulation* ("Principles").² IOSCO intends the Methodology to illustrate IOSCO's interpretation of its Principles.

This Methodology does not alter or expand the Principles.

A. Background of the Principles

The Principles set out a broad general framework for the regulation of securities,³ including the regulation of (i) securities markets, (ii) the intermediaries that operate in those markets, (iii) the issuers of securities, and (iv) the sale of interests in, and the management and operation of, collective investment schemes. The objectives of that framework are:

- (1) To protect investors.⁴
- (2) To ensure fair, efficient, and transparent markets.
- (3) To reduce systemic risk.

The Principles were adopted by the IOSCO President's Committee at IOSCO's Annual Conference in September, 1998.⁵ The 110 Members represented on the IOSCO

² IOSCO Public Document No. 125, *Objectives and Principles of Securities Regulation*, IOSCO Presidents' Committee (as updated, February 2003).

³ As indicated in the Principles, the term "securities" should be understood to include derivatives where the context permits. Principles, footnote 1.

⁴ For purposes of this Methodology, in the case of derivatives markets, the term "investor" includes the term "customer."

⁵ The President's Committee's adopted the Principles as "a valuable source of information on principles that underlie effective securities regulation and on the tools and techniques necessary to give effect to those principles..." The President's Committee further found that:

just, efficient and sound domestic markets are critical components of many national economies and that domestic securities markets are increasingly being integrated into a global market, the Objectives and Principles encourage countries to improve the quality of their securities regulatory systems; and the Objectives and Principles represent international consensus on sound prudential principles and practices for the regulation of securities markets.

At the same meeting, IOSCO indicated that it welcomed the efforts of other groups to strengthen financial markets and to improve the level of investor protection, in particular, work of the G-22 economies related to enhancing transparency and disclosure of information, strengthening financial systems in national

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President's Committee represent a broad spectrum of markets of various levels of complexity and development, of different sizes, operating in different cultural and legal environments. IOSCO resolutions, which provide content to the more broadly-stated IOSCO Principles⁶ and cited IOSCO reports are a valuable source of information that should be consulted on the Principles and the tools and techniques to achieve their implementation.⁷ The Principles were updated as of May 2003 to cross-reference additional IOSCO reports and resolutions to each Principle.

The IOSCO Principles are one of twelve standards and codes (including those on clearing and settlement) highlighted by the Financial Stability Forum as key to sound financial systems and deserving priority implementation.⁸ IOSCO, as the international standard setter for securities regulation, is the expert body responsible for interpretation of the Principles. Further articulation of how to apply the Principles pursuant to this Methodology also helps to effectuate the general objectives of IOSCO as expressed in its By-Laws, in particular that securities authorities should cooperate to ensure better regulation of the markets on the domestic and international level by establishing standards, among other things.

The Principles have formed the basis of an IOSCO-directed, comprehensive self-assessment exercise⁹ and have been used by the World Bank and the International

economies and globally. See also the *Resolution of the Presidents' Committee on Adoption of the IOSCO Objectives and Principles of Securities Regulation* (September 1998).

⁶ The Principles were the result of an extended drafting exercise headed by the three Chairmen of the Executive, Technical and the Emerging Markets Committees of IOSCO. In addition to the special Task Force that concluded the drafting, there was also a consultation period between May 1998 and the final submission of the Principles to the Committees for approval.

⁷ Principles, page 2. A full numerical list of IOSCO Resolutions and Public Documents is set out in Annexures 1 and 2, respectively, to the Principles. IOSCO Presidents' Committee Resolutions and IOSCO Public Documents also are available on the IOSCO internet website at <http://www.iosco.org/library/>, catalogued by reference to the month and year of their issuance. Citations to IOSCO Resolutions and Public Documents in this Assessment Methodology include a reference both to the number of the document on the respective lists in the Annexures to the Principles and to the month and year of their issuance.

⁸ <<http://www.fsforum.org/Standards/KeyStds.html>> The Financial Stability Forum (FSF) was organized as an initiative of the Finance Ministers and Central Bank Governors of the G7 countries. It is comprised of national authorities responsible for financial stability in significant international financial centers, namely treasuries, central banks, and supervisory/regulatory agencies; sector-specific international groupings of standard setters; international financial institutions charged with monitoring and fostering implementation of standards; and committees of central bank experts concerned with market infrastructure and functioning. Current national jurisdictions represented include Australia, Singapore, the Netherlands and Hong Kong as well as the G7 countries. IOSCO has contributed actively to the work of the FSF, which has urged commitment by national authorities to the implementation of 12 key standards and codes of which the *IOSCO Objectives and Principles of Securities Regulation* is one.

⁹ This exercise involved the development and completion by IOSCO Members of six surveys, as follows: a high level survey as to the regulator's opinion of the level of implementation of each Principle in its jurisdiction and five more detailed surveys intended to draw information that would facilitate documentation that the Principles in fact have been implemented related to the regulator (including enforcement and cooperation), issuers, collective investment schemes, market intermediaries and secondary markets. A checking exercise also was conducted through IOSCO's regional committees led by regional coordinators. This exercise provided feedback on the extent to which the responses of individual jurisdictions to these surveys were clear, complete, and consistent.

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Monetary Fund (hereinafter referred to together as IFIs, or International Financial Institutions) in the Financial Sector Assessment Program.¹⁰ Assessors using this Methodology should refer to the assessed jurisdiction's responses in the self-assessment exercise as a first step in the conduct of an assessment.¹¹

B. Purpose of Developing an Assessment Methodology and Assessment Measures

The IOSCO Principles were drafted at a broad conceptual level to accommodate the differences in the laws, regulatory framework, and market structures among its Member jurisdictions. In drafting the Principles, IOSCO concluded that it should avoid being overly prescriptive in its requirements while, at the same time, providing sufficient guidance as to the core elements of an essential regulatory framework for securities activities. Because the Principles are broadly stated, experience with assessments to date indicates that the quality of assessments would be enhanced if assessors had written guidance from IOSCO and a set of criteria (benchmarks) by which to assess a jurisdiction's implementation of each individual principle. The IOSCO Executive, Technical and Emerging Markets Committees, endorsed the development of benchmarks for assessing the Principles at the IOSCO Annual Conference in Istanbul in May, 2002. Those Committees agreed that the criteria establishing the benchmarks should be as objective as reasonably possible and should permit the assessor to assign a jurisdiction to one of the following assessment categories:

Fully Implemented: A Principle will be considered to be *Fully Implemented* whenever all assessment criteria (as specified in the benchmarks) are generally met without any significant deficiencies.

Broadly Implemented: A Principle will be considered to be *Broadly Implemented* whenever a jurisdiction's inability to provide affirmative responses to applicable Key Questions for a particular Principle are limited to the Questions excepted under the Principle's *Broadly Implemented* benchmark and, in the judgment of the assessor, such exceptions do not substantially affect the overall adequacy of the regulation that the Principle is intended to address.

Partly Implemented: A Principle will be considered to be *Partly Implemented* whenever the assessment criteria specified under the *Partly Implemented* benchmark for that Principle are generally met without any significant deficiencies.

Not Implemented: A Principle will be considered to be *Not Implemented* whenever major shortcomings are found in adhering to the assessment criteria as specified in the *Not Implemented* benchmark.

¹⁰ The joint World Bank/IMF Financial Sector Assessment Program (FSAP), initiated in April 1999, seeks to diagnose potential vulnerabilities and analyze development priorities in the financial sectors of member countries of the IFIs.

¹¹ See footnote 9, *supra*

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Not Applicable: A Principle will be considered to be *Not Applicable* whenever it does not apply given the nature of the securities market in the given jurisdiction and relevant structural, legal and institutional considerations. Criteria defining this assessment category are not indicated for every Principle.

It is understood that either “yes” or “no” answers to the Key Questions used for testing implementation should be augmented by explanations that refine and explain the status of implementation in the context of a particular jurisdiction with reference to the foregoing guidance on assessment categories and that answers might be qualified to explain any departure from a full “yes” or full “no” response.

The methodology sets out clear guidance on the Key Questions that must be answered in the affirmative for a jurisdiction to score a *Fully, Broadly* or *Partly Implemented* rating. Nonetheless, assessors should consider the materiality of any weaknesses and the applicability of Key Questions to the jurisdiction when making assessments of compliance with the Key Questions. Where the Key Questions refer to the existence of specific powers or authorities, the judgment as to implementation will generally be precisely specified, limited only by applicability. However, where the Key Questions address the sufficiency of resources or the sufficiency in application of a system of enforcement or effective achievement of specific regulatory functions, the jurisdiction and the assessor may need to make a judgment as to the sufficiency of the program or related resources or degree of achievement. Although the Methodology contemplates that judgment must be applied in assigning assessment categories in these circumstances along the spectrum between *Partly* and *Fully Implemented*, the reasons for such judgments should be expressed by reference to the Key Questions, the assessment criteria in the benchmarks, and the related objectives of regulation expressed in the Key Issues and should be documented.

It is also expected that the status of implementation will be tested as of a specific point in time, that is, the time of the assessment. Where changes are planned, the manner in which those changes further implement the Principles, the timetable for their effectuation and the reasonableness of the timetable should be reflected in the comments, but should not alter the assignment of an assessment category. Where new legislation, programs or procedures have been adopted recently and are untested in their application, the jurisdiction may receive a *Fully Implemented* status only as to having in place the necessary powers, and/or the design of necessary programs, to effectuate the affected principle and not as to full implementation of the powers or the program designed to use those powers.¹² Additionally, failure actually to use the powers, or to apply the program, however well designed, may also implicate an assessment of the existence of the powers.

Wherever a regulatory framework is assessed to be *Broadly, Partly, or Not Implemented* with respect to a particular Principle, recommendations should be proposed for achieving

¹² If, however, the regulator’s prior program would have been *Fully Implemented* and the new program would be an enhancement, the jurisdiction should have an opportunity to demonstrate this and should not be penalized for improving its program.

full implementation. Where a jurisdiction has adopted, but not yet implemented new legislation or procedures, the assessor may refer to these in its recommendations.

C. Scope of This Methodology and Intended Scope of Assessments

This Methodology is intended to apply to the markets, intermediaries, and products addressed by the Principles and to take account of the actual configuration of the markets, the stage of their development, and participation therein. As stated in the Principles, the words “securities markets” are used, as the context permits, to refer compendiously to the various market sectors, including derivatives markets.¹³ The Methodology, however, does not apply to currency, bullion, or physical commodity markets, for example, except to the extent that securities intermediaries deal for customers in such markets. The Methodology also contains information on the legal framework relevant to meeting the objectives addressed by the Principles.¹⁴

D. The Assessment Process

1. *Implementation Intended to Be a Dynamic and Constructive Process for Regulatory Improvement*

The assessment is not an end in itself. Rather, assessment should be viewed primarily as a tool for identifying potential gaps, inconsistencies, weaknesses, and areas where further powers or authorities may be necessary, and as a basis for framing priorities for enhancements or reforms to existing law, rules and procedures. The methodology specifically contemplates that the assessment process will involve a dialogue in which the regulator will explain the details of its market structure, laws and regulatory program and how, in view thereof, the regulator believes its regulatory program addresses the Key Questions and Key Issues so as to meet the objectives of the Principles. In this regard, IOSCO has made clear that the Principles are not intended to be a pure checklist.

2. *Adequacy of Implementation Depends on the Level of Development and Complexity of the Market*

As the Principles make clear:

There is often no single correct approach to a regulatory issue. Legislation and regulatory structures vary between jurisdictions and reflect local market conditions and historical development. The particular manner in which a jurisdiction implements the objectives and principles described in this document must have regard to the entire domestic context, including the relevant legal and commercial framework.¹⁵

¹³ The Principles are not, however, specifically tailored to address all issues particular to derivatives markets. See also Principles, Section 13.2.

¹⁴ Book II Annex 1.

¹⁵ Principles, Section 2 (emphasis added). Securities law and regulation cannot exist in isolation from other laws; there must be an appropriate and effective legal, tax and accounting framework. This may include framework documents, such as a constitution or charter as appropriate. The assessor needs to be

Consistently, this Methodology should not be interpreted as limiting the specific techniques or actions that may be taken to achieve sound securities regulation, provided that the objectives of the Principles are met. Accordingly, in order to apply this Methodology in a manner that appropriately reflects the nature of the market situation in the jurisdiction being assessed, it will be necessary to provide, or to obtain, a complete and clear description of a jurisdiction's capital markets as part of any assessment. Markets with a single or a few issuers, that are totally domestic in nature, or that are predominantly institutional, will pose different questions and issues as to the sufficiency of application of the Principles, and as to the potential vulnerabilities likely to arise from their non-application, than jurisdictions where there are substantial numbers of retail participants, intermediaries frequently are part of complex groups, issuers are established in other jurisdictions, or the markets have other international or cross-border components.

As stated in the Principles, the Regulator frequently should review the particular way in which securities regulation is carried out because the markets themselves are in a constant state of development and the content of regulation also must change if it is to facilitate and properly regulate these evolving markets. The means to give effect to the Principles therefore should be expected to change over time.¹⁶

3. *How to Use the Methodology*

This Methodology addresses each Principle in detail. It sets out the Key Issues addressed by each Principle, the Key Questions relevant to assessing how those Key Issues are addressed, and Benchmarks for evaluating the level of implementation. Where necessary, further explanatory material is provided.

The Methodology envisions that the assessor will establish bases for testing whether the objective of the Principle is sufficiently met from two perspectives: (i) from a legal (or design) perspective, by identifying the powers and authorities conferred on the regulator, the relevant provisions of applicable laws, rules and regulations, and the programs or procedures intended to implement these that form the framework of securities regulation in the jurisdiction; and (ii) from the perspective of the exercise of those powers and authorities in practice, by documenting or otherwise measuring, through statistics, interviews of regulators, regulated firms, and market participants, and other methods, how the powers and responsibilities contained in the laws, rules and regulations are being exercised and whether enforcement of the relevant framework is effective. It is understood that, with respect to judging the effectiveness of the framework from a legal perspective, understanding of the basic legal structure of the jurisdiction is important, and from an empirical perspective, the fact-finding processes need to be carefully designed.

aware of the basic legal structure of a jurisdiction, including its civil, commercial and criminal law. Principles, Annexure 3

¹⁶ Principles, p.3.

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Where firms, products or transactions are exempted from regulatory requirements or where the regulator has discretion to grant such exemptions, the reason the exemption is conferred and the process by which it is conferred should be transparent, give similar results for similarly situated persons or sets of circumstances, and be explainable in the context of the Principles.

In assigning Benchmarks, the assessor should be aware that the Principles with respect to the Regulator and Enforcement and Cooperation should be considered to be applicable to all jurisdictions, whether or not they have a market. In contrast, the other Principles that relate to regulatory functions may not apply to some jurisdictions.

For example, if a jurisdiction does not operate or permit direct access to a secondary market, the provisions relating to secondary markets may not apply. However, even in a jurisdiction without its own secondary market, there should be laws that permit the jurisdiction to combat insider trading or other market misconduct originating from its jurisdiction into other jurisdictions.

The ability to test implementation will understandably be limited by the scope of the inquiry, the assessor's need to rely in certain respects on statistical and anecdotal information, and the fact that implementation will be as of a point in time and not continuing or periodic. Generally, an assessment of the Principles assesses only the quality of securities regulation in a jurisdiction. There may be other factors (such as the economic and political climate) that affect consistent delivery of a fair and equitable regulatory system.

Finally, if the assessment of the Principles is undertaken in connection with the assessment of other standards and codes, the assessments would benefit from coordination. To that end, Annex 2 to this Methodology provides guidance on the relationship of the Principles to certain other of the Financial Stability Forum's Key Standards.¹⁷ Any assessment of implementation cannot be expected to provide assurance against a political or economic failure or the possibility that a sound regulatory framework can be circumvented.

E. Organization of the Methodology and Annexes.

The Assessment Methodology contained in Book One [as approved by IOSCO] is divided into two parts:

Part I provides an introduction to the origin of the Principles, background on IOSCO's self-assessment process; and information on performing an assessment.

Part II provides a principle-by-principle analysis containing the following: Key Issues, Key Questions, and Benchmarks. This analysis, organized in the same manner as the

¹⁷ Book II, Annexes 2-1 through 2-4 on the concordance (relationships) of the Principles with international standards covering anti-money laundering, governance, transparency, and clearing and settlement.

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Principles themselves, is divided into nine sections. The first four sections, covering the Regulator, Self-Regulation, Enforcement, and Cooperation, describe the powers and role of the regulator. The second five sections, covering Issuers, Collective Investment Schemes, Market Intermediaries, Secondary Markets, and Clearance and Settlement, reflect each of the five functional areas of securities regulation and are intended to address the objectives of securities regulation in practice. Each section is preceded by an explanatory preamble and scope setting section, which introduces and provides guidance to understanding the section. Each individual Principle is also preceded by an explanatory preamble.

The Annexes contained in Book Two are a compilation of related reference materials and aids, which unless approved by IOSCO as a separate project, have not been approved by IOSCO:

Book II includes Annexes containing materials prepared for ease of reference for self-assessors and third party assessors that describe the general legal framework desirable for an effective securities regulatory system and related infrastructure; correlate through concordances the provisions of the Principles and certain of the Key Standards of the Financial Stability Forum; compare IOSCO's self-assessment surveys with the Key Questions in the Assessment Methodology; set out a possible action plan for how to prioritize needed regulatory enhancements where comprehensive change is needed; and include the separate assessment methodology for securities settlement systems developed jointly by the Committee on Payment and Settlement Systems of the Group of Ten Countries and IOSCO. Book II also contains a sample self-assessment report template and Benchmark Worksheet with directions for completion [as well as a CD-ROM with the electronic version of the template], which assessors can use to assist in completing their assessments.

II. PRINCIPLE-BY-PRINCIPLE ANALYSIS

A. Principles Relating to the Regulator

1. *Preamble:*

In this Methodology, the regulator refers to the authority or authorities responsible for regulating, overseeing and supervising securities markets. Responsible, or competent, authority(ies) are those with jurisdiction over each of the issues addressed in the Principles and this Methodology under the headings: Issuers, Collective Investment Schemes, Market Intermediaries and Secondary Markets (including clearing and settlement) and may include other law enforcement, governmental and regulatory bodies.

The Principles do not prescribe a specific structure for the regulator.

In this Methodology, the term “regulator” is used compendiously.

There need not be a single regulator. In many jurisdictions, the desirable attributes of the regulator set out in the Principles are in fact the shared responsibility of two or more government or quasi-government agencies with governmental powers.¹⁸

The Principles establish the desirable attributes of a regulator. An independent and accountable regulator with appropriate powers and resources is essential to ensure the achievement of the three core objectives of securities regulation. The Principles consider the enforcement and market oversight work of the regulator and the need for close cooperation between regulators essential to achievement of the regulatory function. The potential role of self-regulatory organizations and the desirable attributes of such organizations are separately addressed under Principles 6 and 7.

The regulator and the effectiveness of its actions should be assessed in the context of the regulatory framework and the legal system of the jurisdiction being assessed. The regulator should also be assessed taking into account the situation, and stage of development, of the market of the assessed country (see the Introduction to this Methodology).

Principles 1 to 5 closely interrelate with Principles 8 to 13. Therefore, evaluations of these Principles should be consistent. For example, it should be impossible to conclude

¹⁸ The term “Regulator” in this Methodology, as the context requires, refers to all competent authorities exercising the powers described herein. To the extent objectives or tasks are to be achieved or powers exercised by the “regulator,” a jurisdiction should be deemed to have implemented the Principles as long as one of the competent authorities can achieve each individual objective or task or exercise a specific power even if the various objectives or tasks are achieved, or the various powers are exercised, by several different law enforcement, governmental and regulatory authorities. See also Principles, Section 6 footnote 11. Where the term “regulatory counterpart” is used, it means another regulator with similar competence. Where the term “governmental authority” is used, the power referred to may be vested in an authority other than the securities regulator.

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that Principle 3 is fully implemented if the regulator is not endowed with comprehensive surveillance powers as required under Principle 8.

In every case, regulators should be held accountable for issuing and implementing rules and regulations necessary to achieve the key core objectives of securities regulation, monitoring whether the objectives are achieved, and taking enforcement or other appropriate action when there is a violation or lack of compliance with regulatory requirements within the context of their own legal and regulatory framework. Regulators also should be required to implement the regulatory framework responsibly, fairly and effectively.

2. *Scope*

The assessor should obtain a comprehensive overview of a given jurisdiction's regulatory system. As the responsibility for securities regulation can be shared by more than one competent authority, the assessor should obtain information that reflects each authority's structure, powers, scope of responsibility and operations. For example, in some jurisdictions, market intermediaries, other than securities firms, e.g., banking or credit institutions; insurance providers; and retirement, pension and super-annuation funds, may engage in the securities activities listed above, but may be subject to a different regulatory authority, for all or certain of their activities.

Where more than one authority is responsible, the assessor should obtain a description of the division of responsibility with respect to each of the functional areas of regulation identified above and the details of cooperative arrangements among the authorities.

3. *Principles 1 through 5*

Principle 1	The responsibilities of the regulator should be clear and objectively stated.
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The desirable attributes of a regulator(s) include an organizational structure and powers that permit it to achieve the basic objectives of securities regulation. In assessing this Principle, the assessor should consider whether, and how, the legal provisions that authorize and provide for the operation of the regulator demonstrate that the regulator can perform its duties, according to procedures and objectives predefined by the relevant regulatory framework. The assessor also should assess whether the arrangements in place demonstrate the ability of the regulatory framework to create and implement a system intended to protect investors, provide fair, efficient and transparent markets, and reduce systemic risk.

Key Issues¹⁹

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 generally should not be subject to inconsistent regulatory requirements.
3. There should be effective cooperation among responsible authorities, through appropriate channels.²⁰

Key Questions

1. Are the regulator's responsibilities, powers and authority:²¹
 - a) Clearly defined and transparently set out, preferably by law, and in the case of powers and jurisdiction, enforceable?
 - b) If the regulator can interpret its authority, are the criteria for interpretation clear and transparent?

¹⁹ Principles, Section 6.2.

²⁰ Id., footnote 13. See also Principles 11 and 12.

²¹ Regulatory discretion may be necessary to meet regulatory objectives in a rapidly evolving market, but how the scope of such discretion is determined and the manner of its exercise is subject to review is relevant to the regulator's ability to act responsibly, fairly and consistently.

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- c) Is the interpretative process transparent enough to preclude situations in which an abuse of discretion can occur?
2. When more than one domestic authority is responsible:
- a) Does the legislation ensure that any division of responsibility avoids gaps or inequities in regulation?
 - b) Is substantially the same type of conduct generally subject to consistent regulatory requirements?
3. When more than one domestic authority is responsible:
- a) Are there effective arrangements for cooperation and communication of information between responsible authorities through appropriate channels?
 - b) Are responsible authorities required to cooperate and communicate in areas of shared responsibility?
 - c) Are cooperation and communication occurring between responsible authorities without significant limitations?²²

Benchmarks

Fully Implemented

Requires affirmative responses to all applicable Questions except to Questions 2 and 3, if not applicable because there is a single responsible authority.

Broadly Implemented

Requires affirmative responses to all applicable Questions except to Question 2(b), or to Question 3(b), provided that different responsible authorities do not supervise the same entity, i.e., as where prudential and conduct of business supervision of the same entity is performed by different regulatory authorities.

Partly Implemented

Requires affirmative responses to all applicable Questions except to Questions 1(c) and 2(b), and to Question 3(b), if more than one responsible authority supervises the same entity.

²² Measures to protect the confidentiality of non-public information consistent with permitted uses should not be considered significant limitations. See also Principle 12.

PRINCIPLES RELATING TO THE REGULATOR

Not Implemented

Inability to respond affirmatively to one or both of Questions 1(a) and 1(b) and, if applicable, one or more of Questions 2(a), 3(a) or 3(c).

Explanatory Notes

Where the responsibilities for securities regulation are shared by more than one regulator and there are differences in the responsibilities and powers of those regulators, the assessment should identify each of the relevant regulatory authorities and take into consideration whether the responsibilities and powers of the regulators taken in combination are sufficient to address each component of the Principles and the Key Questions and Key Issues thereunder. This will require an explanation of how powers and responsibilities considered relevant in the Methodology are distributed and executed in a multi-unit jurisdiction or where regulatory powers are distributed by function, security, service or entity.

In this respect, the Principles are neutral as to whether securities regulation can be distinguished by security, function, service, entity, and/or type of transaction. What is important is to determine, and to consider, how regulation applies to the financial markets, participants, intermediaries, securities and services that characterize the jurisdiction being assessed.

Gaps should be construed to mean gaps in coverage (not in performance) of areas of the basic elements (functions and objectives) of securities regulation (e.g., collective investment schemes, issuers, market intermediaries, secondary markets, enforcement) which are applicable to, and are not covered by, the system being assessed. The assessor should draw the views of the jurisdiction being assessed regarding gaps and inequities. More specific functional gaps or deficiencies should be treated under the specific Principles related to each element of securities regulation. Evidence should be provided as to how all areas addressed by the Principles are covered and, where there are divisions of authority, effective arrangements exist for cooperation.

Where legislation does not satisfactorily address gaps or inequities and amendment is not possible in the short-term, potential gaps or inequities may be addressed by procedures intended to ensure the avoidance of inequities or gaps as a result of any division of responsibilities, such as protocols or arrangements with other financial services regulators or authorities to assure appropriate and equitable coverage of the functions and objectives of securities regulation.

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

Independence and accountability are inter-related. Independence means the ability to undertake regulatory measures and to take and enforce decisions without external (political or commercial) interference. Accountability means that, in the use of its powers and resources, the regulator should be subject to appropriate scrutiny and review.

Key Issues

*Independence*²³

1. The regulator should be operationally independent from external political interference²⁴ 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 decision making on day-to-day technical matters.
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 should be 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

²³ Principles, Section 6.3.

²⁴ The term “interference” means a formal or informal level and method of contact that affects day-to-day decision making and is unsusceptible to review or scrutiny.

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

Key Questions

Independence

1. Does the securities regulator have the ability to operate on a day-to-day basis without:
 - a) External political interference?
 - b) Interference from commercial or other sectoral interests?²⁵
2. Where particular matters of regulatory policy require consultation with, or even approval by, a government minister or other authority:
 - a) Is the consultation process established by law?
 - b) Do the circumstances, in which consultation is required, exclude decision making on day-to-day technical matters?
 - c) Are the circumstances in which such consultation or approval is required or permitted clear and the process sufficiently transparent, or the failure to observe procedures and the regulatory decision or outcome subject to sufficient review, to safeguard its integrity?
3. Does the securities regulator have a stable and continuous source of funding sufficient to meet its regulatory and operational needs?
4. Are the regulatory authority, the head and members of the governing body of the regulatory authority, as well as its staff, accorded adequate legal protection for the *bona fide* discharge of their governmental, regulatory and administrative functions and powers?²⁶
5. Are the head and governing board of the regulator subject to mechanisms intended to protect independence, such as: procedures for appointment; terms of office; and criteria for removal?

Accountability

6. With reference to the system of accountability for the regulator's use of its powers and resources:

²⁵ Principle 3. Administrative actions, such as licensing or commencement of inspections or investigations ordinarily should be particularly scrutinized for freedom from inappropriate influence.

²⁶ Principle 5.

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- a) Is the regulator accountable to the legislature or another government body on an ongoing basis?
 - b) Is the regulator required to be transparent²⁷ in its way of operating and use of resources and to make public its actions that affect users of the market and regulated entities, excluding confidential or commercially sensitive information?
 - c) Is the regulator's receipt and use of funds subject to review or audit?
7. Are there means for natural or legal persons adversely affected by a regulator's decisions or exercise of administrative authority ultimately to seek review in a court, specifically:
- a) Does the regulator have to provide written reasons for its material decisions?²⁸
 - b) Does the decision-making process for such decisions include sufficient procedural protections to be meaningful?
 - c) Are affected persons permitted to make representations prior to such a decision being taken by a regulator in appropriate cases?²⁹
 - d) Are all such decisions taken by the regulator subject to a sufficient, independent review process, ultimately including judicial review?
8. Where accountability is through the government or some other external agency, is confidential and commercially sensitive information subject to appropriate safeguards to prevent inappropriate use or disclosure?

Benchmarks

Fully Implemented

Requires affirmative responses to all applicable Questions.

Broadly Implemented

Requires affirmative responses to all applicable Questions except to Question 6(b).

²⁷ The regulator must be accountable as a matter of law; the regulator may be considered to be "required" to be transparent, if, as a general principle of administrative law, procedure or practice, its use of its powers and resources generally is transparent.

²⁸ The regulator need not be required by legislation to give written reasons provided that it has formal written procedures as to when it will do so.

²⁹ For example, a warning letter may not be subject to additional process.

PRINCIPLES RELATING TO THE REGULATOR

Partly Implemented

Requires affirmative responses to all applicable Questions except to either Question 2(b) or 2(c), and to Questions 4, 5, 6(b) and 7(c).

Not Implemented

Inability to respond affirmatively to one or more of Questions 1(a), 1(b), 2(a), both 2(b) and 2(c), 3, 6(a), 6(c), 7(a), 7(b), 7(d) or 8.

Explanatory Notes

The balance between independence and accountability is delicate. The Principles take no position on location of the regulator within the governmental structure. Nevertheless, in different circumstances the safeguarding of independence must be particularly scrutinized. Not only should the allocation of regulatory responsibilities, the framework for accountability and procedures or other mechanisms in place to achieve independence be considered, but also the actual operation of the relationship between the regulator and any governmental overseer should be considered. If possible, the effect of such inter-relationship should be reviewed in specific cases. For example, in some jurisdictions, rules or policies may require approval by a government minister or other authority or other important regulatory matters may require consultation with or approval by a government minister or other authority. Also, sometimes matters are reviewed within the government for compliance with applicable law. The circumstances in which such consultation or approval is required or permitted should be clear and the process sufficiently transparent or subject to review as to safeguard its integrity.

Criteria for decision-making also can insulate the process from inappropriate political interference. For example, the ability to reverse licensing decisions at the ministerial level without clear criteria both for the refusal to license and related decision-making process would inappropriately infringe independence. A stable source of funding is critical because operational independence can be compromised if funding can be curtailed by external action. The assessor may inquire of the assessed jurisdiction as to whether the source of funds can adversely affect their accessibility.

As this Principle tests independence, the ability to protect sensitive information passed to other decision-making authorities should be part of the regulatory framework to prevent undue interference with the regulatory authorities' operations. The safeguards in place must be part of the system.

One example of adequate legal protection for regulators acting in *bona fide* performance of regulatory functions would be qualified immunity from personal liability for actions taken in good faith within the scope of the regulator's authority. Other arrangements may also be possible. The adequacy and type of legal protection for regulators acting in *bona fide* performance of their regulatory functions must be evaluated according to the legal system applicable in the assessed jurisdiction.

PRINCIPLES RELATING TO THE REGULATOR

Formal consultation with commercial interests, including those subject to regulation, as contemplated under Principal 4, does not impair independence.

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

The powers and resources of the regulator should be consistent with the size, complexity and types of the markets that it oversees and its need to meet the functions contained in these Principles. The assessor should determine after assessing all the Principles and the effectiveness of the jurisdiction's regulatory program if there is a substantial basis for concluding that the powers, resources and capacity of the regulator are sufficient.

Key Issues³⁰

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.

Key Questions³¹

1. Are the powers and authorities of the regulator sufficient, taking into account the nature of a jurisdiction's markets and a full assessment of these Principles to meet the responsibilities of the regulator(s) to which they are assigned?
2. With regards to funding:
 - a) Does the regulator's funding reflect the needs of the regulator in supervising a given market, taking into account the size, complexity and types of functions subject to its regulation, supervision or oversight?
 - b) Can the regulator affect the operational allocation of resources once funded?

³⁰ Principles, Section 6.4. See also the Key Questions on enforcement and cooperation under Principles 8, 9, 11 and 13 and Key Questions relating to regulatory powers related to Issuers, Market Intermediaries, Collective Investment Schemes and Secondary Markets.

³¹ The answers to these questions should be consistent with powers and authorities discussed in other sections.

PRINCIPLES RELATING TO THE REGULATOR

3. Does the level of resources recognize the difficulty of attracting and retaining experienced and skilled staff?
4. Does the regulator ensure that its staff receives adequate ongoing training?

Benchmarks

Fully Implemented

Requires affirmative responses to all applicable Questions.

*Broadly Implemented*³²

Requires affirmative responses to all applicable Questions except to Question 3.

Partly Implemented

Requires affirmative responses to all applicable Questions except to Questions 2(b), 3 and 4.

Not Implemented

Inability to respond affirmatively to one or both of Questions 1 and 2(a).

Explanatory Notes

The powers granted to the regulator should be commensurate to the functions committed to the regulator. Where there is more than one regulator, the powers required for implementation may be distributed among them. The powers granted, taken together, should be sufficient to provide the ability to achieve implementation of the other Principles set forth in this Methodology. The assessor may wish to review this Principle after the full assessment is complete.

In complex markets, technology may be necessary to assure efficient discharge of regulatory functions. An appropriate program of investor education also may assist the regulator in carrying out its responsibilities. Investor education is assessed under Principle 4.

The regulator should be given an opportunity to demonstrate to the assessor that its powers and funding are adequate and, in particular, how they are deployed to achieve its objectives and legal and regulatory responsibilities; for example, how the regulator measures effectiveness, promptness of action, level of coverage and ability to meet its priorities.

³² For *Broadly* and *Partly*, the availability and sufficiency of resources in fact may need to be evaluated along the spectrum of *Fully* to *Partly* with guidance from the assessed jurisdiction.

PRINCIPLES RELATING TO THE REGULATOR

Turnover of staff may be an indication of inability to attract and retain qualified staff. The assessor should inquire further about the reasons.

Principle 4 The regulator should adopt clear and consistent regulatory processes.

Clear, consistent, transparent procedures and processes are part of fundamental fairness and of a framework for developing regulatory decisions and for undertaking regulatory actions that assures accountability. Transparency policies must, however, balance the rights of individuals to confidentiality, and regulators' enforcement and surveillance needs, with the objective of fair, equitable and open regulatory processes.

Key Issues³³

Clear and Equitable Procedures with Consistent Application

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,³⁴ 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.³⁵
 - c) Have regard to the cost of compliance with regulation.
3. The regulator should observe standards of procedural fairness.

³³ Principles, Section 6.5.

³⁴ Principles, footnote 14. In some operational areas and in some cases, particularly in the areas of surveillance and enforcement, consultation and disclosure may be unnecessary or inappropriate as this may compromise the effective implementation of policy.

³⁵ That is policies with respect to Issuers, Collective Investment Schemes, Market Intermediaries and Secondary Markets.

PRINCIPLES RELATING TO THE REGULATOR

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.

Investor Education

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

Key Questions

Clear and Equitable Procedures

1. Is the regulator subject to reasonable procedural rules and regulations?
2. Does the regulator:
 - a) Have a process for consultation with the public, or a section of the public, including those who may be affected by the policy, for example, by publishing proposed rules for public comment, circulating exposure drafts or using advisory committees or informal contacts?
 - b) Publicly disclose and explain its policies, not including enforcement and surveillance policies, in important operational areas, such as through interpretations of regulatory actions, setting of standards, or issuance of opinions stating the reasons for regulatory actions?
 - c) Publicly disclose changes and reasons for changes in rules or policies?
 - d) Have regard, in the formulation of policy, to the costs of compliance with regulation?³⁶
 - e) Make all rules and regulations available to the public?³⁷
 - f) Make its rulemaking procedures readily available to the public?³⁸
3. In assessing procedural fairness:
 - a) Are there rules in place for dealing with the regulator that are intended to ensure procedural fairness?

³⁶ See Explanatory Note.

³⁷ For example, on its web site or through readily accessible reports. See also Principle 1.

³⁸ Principle 2.

PRINCIPLES RELATING TO THE REGULATOR

- b) Is the regulator required³⁹ to give reasons in writing for its decisions that affect the rights or interests of others?
- c) Are all material actions of the regulator in applying its rules subject to review?
- d) Are such decisions subject to judicial review where they adversely affect legal or natural persons?
- e) Are the general criteria for granting, denying, or revoking a license made public, and are those affected by the licensing process entitled to a hearing with respect to the regulator's decision to grant, deny, or revoke a license?

Transparency and Confidentiality

- 4. If applicable, are procedures for making reports on investigations public consistent with the rights of individuals, including confidentiality and data protection?

Investor Education

- 5. Does the regulator play an active role in promoting education in the interest of protecting investors?

Consistent Application

- 6. Are the regulator's exercise of its powers and discharge of its functions consistently applied?

Benchmarks

Fully Implemented

Requires affirmative responses to all applicable Questions.⁴⁰

Broadly Implemented

Requires affirmative responses to all applicable Questions except to Question 2(d).

Partly Implemented

Requires affirmative responses to all applicable Questions except to Questions 2(b), 2(d), 2(f) and 5.

³⁹ The regulator need not be required by legislation to provide reasons, provided that it has written procedures as to when it will do so.

⁴⁰ Principle 2. If there is no power to make reports public, then there would be no need to protect confidentiality.

Not Implemented

Inability to respond affirmatively to one or more of Questions 1, 2(a), 2(c), 2(e), 3(a), 3(b), 3(c), 3(d), 3(e), 4 or 6.

Explanatory Notes

The assessor should establish whether there are specific laws, rules or procedures that govern the administrative structure and whether these rules are clear, accessible and transparent. Such rules would assist in assuring that procedures are consistently applied, comprehensible, transparent to the public and fair and equitable.

In some operational areas, and in some cases, particularly in areas of surveillance and enforcement, consultation and disclosure may be unnecessary or inappropriate as this may compromise the effective implementation of regulatory policy.

There may be different levels of, or procedures for, review of different types of regulatory actions. For example, rulemaking may be subject to different review procedures than actions with respect to granting licenses or taking enforcement action. This is not inconsistent with the Principles if the review procedures are transparent and equitably applied.⁴¹

An effective consultation process may be responsive to the need to take into account the impact of regulation and to have regard to the costs of compliance with regulation. The regulator should be able generally to assess the use of its resources. A regulator is not required to conduct a specific cost/benefit analysis in order to be found to have regard for the cost of compliance when framing regulatory policy.

Interviews with affected parties and other documentation may be necessary to confirm whether procedures are, in fact, consistently applied, fair and equitable and the market is open to fair competition practices.

The regulator also should be invited to explain what sort of investor education activities or programs are promoted by the regulator within the assessed jurisdiction.

⁴¹ Principle 2, Key Question 7, *supra*.

Principle 5 The staff⁴² of the regulator should observe the highest professional standards including appropriate standards of confidentiality.

This Principle refers to the integrity and the means for achieving and demonstrating the integrity of the regulatory authority and its staff. Only the highest professional standards of conduct are appropriate to achieving the objectives of regulation.

Key Issues⁴³

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 the protection of personal data.
 - d) The observance of procedural fairness.
2. Failure to meet standards of professional integrity should be subject to sanctions.

Key Questions

1. Are the staff of the regulator required to observe legal requirements or a "Code of Conduct" or other written guidance, pertaining to:
 - a) The avoidance of conflicts of interest?
 - b) Restrictions on the holding or trading in securities subject to the jurisdiction of the regulatory authority and/or requirements to disclose financial affairs or interests?
 - c) Appropriate use of information obtained in the course of the exercise of powers and the discharge of duties?
 - d) Observance of confidentiality and secrecy provisions and the protection of personal data?

⁴² To comply with Principles 2 and 4, Principle 5 also should be considered to apply to the head and members of the regulatory authority.

⁴³ Principles, Section 6.6.

PRINCIPLES RELATING TO THE REGULATOR

- e) Observance by staff of procedural fairness in performance of their functions?
2. Are there:
- a) Processes to investigate and resolve allegations of violations of the above standards?
 - b) Legal or administrative sanctions for failing to adhere to these standards?

Benchmarks

Fully Implemented

Requires affirmative responses to all applicable Questions.

Broadly Implemented

Requires affirmative responses to all applicable Questions except that there may not be active monitoring of matters under Questions 1(a) and 1(b).

Partly Implemented

Requires affirmative responses to all applicable Questions except that with respect to Questions 1(a) through (e), there may be minor shortcomings in observance of procedures, including no active monitoring under Questions 1(a) and 1(b).

Not Implemented

Inability to respond affirmatively to one or more of Questions 1(a), 1(b), 1(c), 1(d) or 1(e), subject to the departures from full compliance permitted under *Partly Implemented*, or failure to respond affirmatively to either of Questions 2(a) or 2(b).

Explanatory Notes

The Key Questions are intended to address requirements relating to maintenance of high professional standards. The assessor should obtain documentation of specific procedures and how they have been used in specific cases. The assessor should also look at documentation of confidentiality measures and arrangements to avoid conflicts of interest.⁴⁴ For example, guidance on conflicts of interest should address outside employment and holding of other positions, among other things.

⁴⁴ Principle 4.

PRINCIPLES RELATING TO THE REGULATOR

Restrictions on trading could include, for example, pre-clearance of transactions or restrictions on transactions above a specified threshold

B. Principles Relating to Self-Regulation

1. *Preamble*

Self regulatory organizations (SROs) can be a valuable complement to the regulator in achieving the objectives of securities regulation. Various models of self-regulation exist and the extent to which self-regulation is used varies.⁴⁵

Typically, SROs draw on the expertise of their private sector members and, when appropriate, augment regulatory resources by requiring observance of standards that may go beyond government regulation, or permit quicker, more flexible responses to market conditions.⁴⁶

2. *Scope*

Self-regulation may be based on statutorily delegated powers and may encompass the authority to create, amend, implement and enforce rules with respect to entities subject to the SRO's jurisdiction and to resolve disputes through arbitration or other means.⁴⁷

An organization should be classified as an SRO (and subject to assessment under Principle 7) if it has been given the power or responsibility to regulate any part of the securities market or industry.⁴⁸

3. *Principles 6 and 7*

Principle 6 is generally subsumed within Principle 7, and therefore an assessor should assess these two Principles in conjunction. The assessor must identify whether any regulatory activities are undertaken by an SRO(s). If they are not, Principles 6 and 7 are not applicable and need not be assessed. This should be documented.

⁴⁵ Principles, Section 7.2.

⁴⁶ Id.

⁴⁷ Id.

⁴⁸ Principle 6, Key Questions, *infra*.

Principle 6 **The regulatory regime should make appropriate use of self-regulatory organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence and to the extent appropriate to the size and complexity of the markets.**

The Principles recognize the value that a *properly regulated* SRO can play and set out general recommendations for the proper authorization and oversight of SROs. However, the use of SROs, while a policy option, is discretionary, and therefore, the absence of SROs in a jurisdiction should have no assessment implication.

The “appropriate use” of an SRO is related to:

1. The SRO’s capacity to carry out the purposes of relevant governing laws, regulations and SRO rules, and to enforce compliance by its members and associated persons with those laws, regulations and rules as reflected in the SRO’s regulatory authorization requirements and oversight program.
2. The adequacy of the regulator’s oversight.
3. The need for augmentation of regulatory resources.

“Inappropriate use” of an SRO by extension might include the exercise of SRO functions by an unauthorized entity or without regulatory oversight, designation of private sector institutions that demonstrate an insufficient capability to meet standards of authorization or delegation to perform SRO functions, evidence of misuse of quasi-governmental powers, or insufficient performance of the functions of self-regulation.

Key Issues

1. If self-regulation is used, the SRO should be subject to appropriate oversight by the regulator.⁴⁹

Key Questions

Performance of Functions of SRO

1. Are there organizations that:
 - a) Establish rules of eligibility that must be satisfied in order for individuals or firms to participate in any significant securities activity?

⁴⁹ As specified under Principle 7.

PRINCIPLES RELATING TO SELF-REGULATION

- b) Establish and enforce binding rules of trading or business conduct for individuals or firms engaging in securities activities?
- c) Establish disciplinary rules and/or conduct disciplinary proceedings, which have the potential to impose enforceable fines, or other penalties, or to bar or suspend a legal or natural person from participating in securities activities or professional activities related to securities activities?

An affirmative response to Questions 1(a), 1(b) or 1(c) requires assessment of Principle 7.

Explanatory Notes

Use of properly overseen SROs can expand regulatory resources in complex and small markets.⁵⁰

⁵⁰ See also, Principle 3.

Principle 7 SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.

In assessing this Principle the assessor should consider whether an SRO's powers and levels of oversight are consistent with its functions and responsibilities. Like a regulatory authority, an SRO's processes should be fair and consistent, its decisions should be subject to regulatory review, and the protection of confidentiality, data and professional responsibility of staff for its conduct should be similar to that expected of the regulator. The regulator should have full authority to oversee effectively any SRO.

Key Issues

Authorization

1. As a condition of authorization, the legislation or the regulator should require an SRO to demonstrate that it:
 - a) Has the capacity to carry out the purposes of relevant governing laws, regulations and SRO rules, and to enforce compliance by its members and associated persons subject to those laws, regulations, and rules.
 - b) Treats all members of the SRO and applicants for membership in a fair and consistent manner.
 - c) Develops rules that are designed to set standards of behaviour for its members and to promote investor protection.
 - d) Submits to the regulator its rules for review and/or approval, as the regulator deems appropriate, and ensures that the rules of the SRO are consistent with the public policy directives established by the regulator.
 - e) Cooperates with the regulator and other SROs to investigate and enforce applicable laws and regulations.
 - f) Enforces its own rules and imposes appropriate sanctions for non-compliance.
 - g) Assures a fair representation of members in selection of its directors and administration of its affairs.
 - h) Avoids rules that may create anti-competitive situations.

PRINCIPLES RELATING TO SELF-REGULATION

- i) Avoids using the oversight role to allow any market participant unfairly to gain advantage in the market.⁵¹

Oversight

2. Oversight should be on-going to ensure that:
 - a) An SRO meets the conditions of its authorization on an ongoing basis.⁵²
 - b) The government regulator retains the authority to inquire into matters affecting investors or the market.
 - c) Where the powers of an SRO are inadequate to investigate, or otherwise to address, alleged misconduct or where the SRO has a conflict of interest, the regulator conducts any necessary investigation rather than the SRO.
 - d) An SRO provides information to the regulator that allows matters requiring regulatory intervention to be identified at an early stage.⁵³

Professional Standards

3. The SRO should adopt standards of confidentiality for its staff and standards of procedural fairness applicable to its members comparable to those for the regulator.⁵⁴

Conflicts of Interest

4. The SRO should have procedures in place to address potential conflicts of interest.

Key Questions

Authorization or Delegation Subject to Oversight

1. As a condition to authorization, does the legislation or the regulator require the SRO to demonstrate that it:⁵⁵
 - a) Has the capacity⁵⁶ to carry out the purposes of governing laws, regulations and SRO rules consistent with the responsibility delegated to the SRO, and to enforce compliance by its members and associated persons subject to those laws, regulations and rules?

⁵¹ Principles, Section 7.3 ¶ 4.

⁵² Principles, Section 7.3 ¶ 1.

⁵³ Principles, Section 7.3 ¶ 5.

⁵⁴ Principles, Section 7.3 ¶ 6.

⁵⁵ In the case of a newly operational SRO, the applicant should demonstrate that it has programs and procedures in place to meet the conditions of authorization, and ongoing and effective execution of such programs or procedures should be considered a condition of authorization.

⁵⁶ Principles, Section 7.3 ¶ 3.

PRINCIPLES RELATING TO SELF-REGULATION

- b) Treats all members of the SRO, applicants for membership and similarly situated market participants subject to its rules in a fair and consistent manner?
- c) Develops rules that are designed to set standards for its members and to promote investor protection?
- d) Submits to the regulator its rules, and any amendments thereto, for review and/or approval, as the regulator deems appropriate, and ensures that the rules of the SRO are consistent with the public policy directives established by the regulator?
- e) Cooperates with the regulator and other domestic SROs to investigate and enforce applicable laws, regulations and rules?
- f) Imposes appropriate sanctions for non-compliance with its own rules?
- g) Where applicable, e.g., a mutual organization, assures a fair representation of members in selection of its board of directors and administration of its affairs?
- h) Avoids rules that may create anti-competitive situations as defined in the Explanatory Note?
- i) Avoids using the oversight role to allow any market participant unfairly to gain an advantage in the market?

Oversight

- 2. Does the regulator:
 - a) Have in place an effective on-going oversight program of the SRO, which may include:
 - i) Inspection of the SRO;
 - ii) Periodic reviews;
 - iii) Reporting requirements;
 - iv) Review and revocation of SRO governing instruments and rules; and
 - v) The monitoring of continuing compliance with the conditions of authorization or delegation.
 - b) Retain full authority to inquire into matters affecting the investors or the market?
 - c) Take over an SRO's responsibilities where the powers of an SRO are inadequate for inquiring into or addressing particular misconduct or allegations of misconduct or where a conflict of interest necessitates it?

PRINCIPLES RELATING TO SELF-REGULATION

Professional Standards Similar to those Expected of a Regulator

3. Does the law or regulator require the SRO to follow similar professional standards of behavior as would be expected of a regulator:
 - a) On matters relating to confidentiality and procedural fairness?
 - b) On the appropriate use of information obtained in the course of the SRO's exercise of its powers and discharge of its responsibilities?

Conflicts of Interest

4. Does the law or regulator assure that potential conflicts of interest at the SRO are avoided or resolved?

Benchmarks

Fully Implemented

Requires affirmative responses to all applicable Questions.

Broadly Implemented

Requires affirmative responses to all applicable Questions except that, in the case of Questions 1(g) and 1(h), the regulator does not have the power to require that the SRO:

- assures a fair representation of members in the selection of its board of directors and the administration of its affairs; or
- avoids rules that may create anti-competitive situations;

provided that, the SRO has relevant rules and procedures and/or there is general law that addresses these issues and there is not a record of substantial complaint.

Partly Implemented

Requires affirmative responses to all applicable Questions except to Questions 1(g), 1(h) and 4, provided that in the case of Question 4, the regulator can take over actions undertaken by the SRO where these matters are at risk and there is no evidence of obvious abuses.

Additionally, although the SRO may not have the power to assist in investigation of compliance with applicable laws and regulations, the regulator *requires the SRO*, as a condition of authorization and on an ongoing basis, to make all relevant information available to the regulator in regards to Question 1(e).

Not Implemented

Inability to demonstrate that the regulator can require an SRO to meet standards or failure to respond affirmatively to one or more of Questions 1(a), 1(b), 1(c), 1(d), 1(f), 1(i), 2(a), 2(b), 2(c), 3(a) or 3(b) or to Questions 1(e) or 4, absent the qualifications under *Partly Implemented*, and/or a finding that the exercise of SRO functions in practice occurs without oversight or there is demonstrable evidence of abuse or insufficient performance of SRO functions.

Explanatory Notes:

The level and extent of regulatory oversight and the types of needed powers and protections may be affected by the structure of the self-regulatory authority. For example, there may be more concern for conflicts of interest, or appropriate use of self-regulatory resources, in the case of for-profit, demutualized markets. Furthermore, in some markets, certain very specific functions are delegated to self-regulatory authorities and others are not. Assessors must sensibly apply the benchmarks in this case, only requiring oversight of the functions performed and not testing powers or attributes not performed by the SRO. For example, if exchanges perform certain, but not other, SRO functions and are not specifically designated as SROs, those functions should be tested against Principle 7 as applicable even though the exchange is authorized under Principle 25. The assessments for Principle 25 and Principle 7 in this case should be consistent. Reference also may be made to other relevant Principles for testing the adequacy of performance of regulatory functions by SROs where such functions are delegated to the SRO.

Anti-competitive situations may include situations where the SRO (i) acts in an exclusionary, unfair, or inequitable manner when governing access to the SRO or when taking action with respect to enforcement, or (ii) promulgates or interprets SRO rules and procedures in a way that is not fair and equitable to similarly situated market participants. Among other things, regulatory oversight should be directed to the SRO undertaking its responsibilities in a way that unreasonably prevents access to the market or that unreasonably creates barriers to entry in the business of providing investment services that are unrelated to oversight of the market or prudential concerns.⁵⁷

SROs that are public companies also should be subject to the governance provisions applicable to other issuers. See Principles 14 through 16.

⁵⁷ Principles, Section 5.

C. Principles Relating to Enforcement

1. *Preamble*

The complex character of securities transactions and the sophistication of fraudulent schemes require strong and rigorous enforcement of securities laws. The Principles do not consider that what is encompassed by the term “enforcement” should be interpreted narrowly. Instead, that term should be interpreted broadly enough to encompass powers of surveillance and inspection, as well as investigation, such that the regulator should be expected to have the ability, the means and a variety of measures to detect, deter, enforce, sanction, redress and correct violations of securities laws. Principles 8, 9 and 10 are referred to herein as the Enforcement Principles. Together they seek to determine a regulator’s ability to monitor the entities subject to its supervision, to collect information on a routine and *ad hoc* basis, and to take enforcement action to ensure that persons and entities comply with relevant securities laws.

Reflecting a broad definition of enforcement, Principle 8 deals with the ability of the regulator to perform ongoing supervision and to implement supervisory programs as preventative measures and with the circumstances in, and methods by which, the regulator may obtain information in the course of executing its responsibilities.⁵⁸ Principle 9 deals with the courses of action available to the regulator where a breach of relevant securities laws is identified. Principle 10 requires the regulator to demonstrate how the regulatory system in place, and its own organization, provides for an effective and credible use of its supervisory and enforcement powers. In particular, the regulator should be able to demonstrate that there is a system to take effective investigation and enforcement actions and that such actions, where necessary, have been undertaken to address misconduct or abuses. An effective program, for example, could combine various means to identify, detect, deter and sanction such misconduct. A wide range of possible sanctions could meet the standards according to the nature of the legal system assessed. The regulator, however, should be able to provide documentation that demonstrates that sanctions available (whatever their nature) are effective, proportionate and dissuasive. Sections of the Principles that address specific functions also address possible sanctions.

The assessment under these Principles requires a careful consideration of the legal system in which the regulator operates. The Principles do not prescribe any specific model to be followed and contemplate both civil law and common law systems. There are several models that have been shown to be effective. These include models in which responsibilities are shared between several government or quasi-government agencies or in which responsibilities are shared with SROs.

Principles 8, 9 and 10 are interrelated with the specific regulatory functions and responsibilities described under the Principles sections on Issuers, Collective Investment Schemes, Market Intermediaries and Secondary Markets. Assessors should ensure that

⁵⁸ Principles, Section 8.3.

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there are no inconsistencies in the evaluation of Principles 8, 9 and 10 and the assessments of the other Principles in the assessed jurisdiction.

2. *Scope*

Mechanisms for ensuring enforcement of securities laws should be in force in all jurisdictions. It is not necessary, however, that the responsibility for all aspects of enforcement of the securities law be given to a single body.

Where enforcement is undertaken by an authority other than the regulator or where enforcement is shared between the regulator and another authority, cooperation among such bodies is critical and the ability to act timely and effectively should be particularly scrutinized.

3. *Principles 8 through 10*

Principle 8 The regulator should have comprehensive inspection, investigation and surveillance powers.
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Reflecting a broad definition of enforcement, Principle 8 is designed to address whether a regulator has the powers to conduct surveillance, undertake investigations, obtain information, and take corresponding enforcement action in relation to *regulated entities* to ensure that they comply with relevant securities laws. It covers the circumstances in, and methods by which, the regulator may obtain information from those entities in the course of its inquiries. Principle 8, in particular, addresses the regulator's authority to conduct ongoing oversight and supervision of regulated entities as preventative measures.

Key Issues

1. The regulator should have the power to require the provision of information in the ordinary course of business, in response to an inquiry or as part of a reporting cycle, or to carry out inspections of regulated market participants' business operations whenever it believes it necessary to ensure compliance with relevant standards. The suspicion of a breach of law should not be necessary to enable the regulator to conduct inspections or require information of regulated entities.⁵⁹
2. The regulator should be able to require the provision of all information reasonably needed to ensure compliance with relevant standards, including books, documents, communications, and statements.⁶⁰
3. Where regulatory enforcement responsibilities are delegated to an SRO or a third party, these parties should be subject to disclosure and confidentiality requirements that are as stringent as those applicable to the regulator.

Key Questions⁶¹

1. Can the regulator inspect a regulated entity's⁶² business operations, including its books and records, without giving prior notice?
2. Can the regulator obtain books and records and request data or information from regulated entities without judicial action, even in the absence of suspected misconduct, in response to:⁶³

⁵⁹ Principles, Section 8.2 ¶2 and footnote 21.

⁶⁰ IOSCO Presidents' Committee, *Resolution on Principles for Recordkeeping, Collection of Information, Enforcement Powers and Mutual Cooperation* (November 1997) ("Resolution on Recordkeeping").

⁶¹ Questions for Principle 8 are generally taken from the Resolution on Recordkeeping, *supra*, and confirmed by IOSCO Public Document No. 126, *Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information* (May 2002) (the "Multilateral MOU").

⁶² "Regulated entity" includes authorized or licensed entities or persons.

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- a) A particular inquiry?
- b) On a routine basis?
3. Does the regulator have the power to supervise its authorized exchanges and regulated trading systems through surveillance?
4. Does the regulator have record-keeping and record retention requirements for regulated entities?
5. Are regulated entities required:
 - a) To maintain records concerning client identity?
 - b) To maintain records that permit tracing of funds and securities in and out of brokerage and bank accounts related to securities transactions?
 - c) To put in place measures to minimize potential money laundering?⁶⁴
6. Does the regulator have the authority to determine or have access to the identity of all customers of regulated entities?
7. Where a regulator out-sources inspection or other regulatory enforcement authority to an SRO⁶⁵ or a third party:
 - a) Does the regulator supervise the outsourced functions of third parties?
 - b) Does the regulator have full access to information maintained or obtained by the third parties?
 - c) Can the regulator cause changes/improvements to be made in the third parties' processes?
 - d) Are these third parties subject to disclosure and confidentiality requirements that are no less stringent than those applicable to the regulator?

Benchmarks

Fully Implemented

Requires affirmative responses to all applicable Questions.

⁶³ Principles, Section 8.2 ¶ 2 and ¶ 4.

⁶⁴ Principles, Section 8.5 ¶ 2.

⁶⁵ In the case of an SRO, the regulator should have these powers as a condition of continuing authorization. See Principle 7.

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Broadly Implemented

Requires affirmative responses to all applicable Questions, except to Question 7(c).

Partly Implemented

Requires affirmative responses to all applicable Questions, except to Questions 7(c) and 7(d), or where the regulator must cooperate with other authorities to obtain records of regulated entities, such cooperation is not sufficiently timely.

Not Implemented

Inability to respond affirmatively to one or more of Questions 1, 2(a), 2(b), 3, 4, 5(a), 5(b), 5(c), 6, 7(a) or 7(b).

Explanatory Note

The Principles dealing with a regulator's specific functional responsibilities with respect to regulated entities (e.g., the Principles for Collective Investment Schemes, Market Intermediaries and Secondary Markets) are inter-related with Principle 8 and there should be no inconsistencies in these assessments.

Principle 9 The regulator should have comprehensive enforcement powers.

While Principle 8 is limited to regulated entities, Principle 9 is intended to have wider application. As in the case of powers, reflecting a broad definition of enforcement, Principle 9 deals with courses of action open to the regulator where a breach of relevant securities laws by any person is identified.

Key Issues

1. The regulator or other competent authority should be provided with comprehensive investigative and enforcement powers including the power: to seek orders or to take action to enforce regulatory, administrative or investigative powers; to impose effective sanctions, or to seek them; or to initiate or refer matters to the criminal authorities.⁶⁶
2. The regulator or other competent authority should be able to obtain data, information, documents, books and records and statements or testimony from any person involved in relevant conduct or who may have information relevant to a regulatory or enforcement inquiry/investigation.
3. As a general matter, these enforcement powers should not compromise private rights of action. Private persons should be able to seek their own remedies (including, for example, for compensation, damages or specific performance of an obligation).⁶⁷
4. Where enforcement or other corrective action requires the action of more than one regulator or other competent authority, prompt cooperation, including information sharing between them, should be possible for investigative and enforcement purposes.⁶⁸

Key Questions

1. Does the regulator or other competent authority within the jurisdiction have the investigative and enforcement power to enforce compliance with the laws and regulations relating to securities activities?
2. Does the regulator or other competent authority within the jurisdiction have the following powers:

⁶⁶ Principles, Section 8.3.

⁶⁷ Principles, Section 8.3 ¶3.

⁶⁸ Principles 1 and 11.

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- a) Power to seek orders, to refer matters for civil proceedings or to take other action to ensure compliance with regulatory, administrative, and investigative powers?
 - b) Power to impose administrative sanctions?⁶⁹
 - c) Power to initiate or to refer matters for criminal prosecution?
 - d) Power to order the suspension of trading in securities or to take other appropriate actions?⁷⁰
3. Does the regulator or other competent authority have the investigative and enforcement power to require from any persons involved in relevant conduct or who may have information relevant to a regulatory or enforcement inquiry/investigation:⁷¹
- a) Data?
 - b) Information?
 - c) Documents?
 - d) Records?
 - e) Statements or testimony?
4. Can private persons seek their own remedies for misconduct relating to the securities laws?⁷²
5. Where an authority other than the regulator must take enforcement or other corrective action, can the regulator share information obtained through its regulatory or investigation activities with that authority?
6. Where the regulator is unable to obtain information in its jurisdiction necessary to an investigation, is there another authority that can obtain the information?
7. If yes, can that authority share the information with the regulator for the regulator's use in investigations and proceedings?

⁶⁹ Principle 8, Key Questions, *supra*. See also the Resolution on Recordkeeping, *supra*.

⁷⁰ Principles, footnote 24. Other actions include the imposition of trading restrictions or requirements on individual market participants, e.g., position limits, reporting requirements, liquidation-only trading, special margin requirements or other corrective actions. Some jurisdictions also can seek compensatory remedies. The specific actions listed in question 2(d), and in this note, are exemplary and are not necessary to receive a *Fully Implemented* assessment provided the regulator can demonstrate that available sanctions are proportionate, dissuasive and effective.

⁷¹ Resolution on Record keeping, *supra*, and the Multilateral MOU, *supra*, and subsequent Questions.

⁷² Such actions need not be taken directly under the securities laws, but could be under provisions within the general law.

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Benchmarks

Fully Implemented

Requires affirmative responses to all applicable Questions and that, where cooperation among authorities is necessary to take action, such action is responsive to the priorities of the securities regulator and timely.

Broadly Implemented

Requires affirmative responses to all applicable Questions, except to Question 4 or there are minor deficiencies in cooperation among authorities.

Partly Implemented

Requires affirmative responses to all applicable questions, except to Questions 3(e), 4 and 7 or the regulator cannot demonstrate that actions within its power are sufficiently timely to address misconduct or abuses.

Not Implemented

Inability to withdraw or suspend a license or inability to respond affirmatively to one or more of Question 1, 2(a), 2(b), 2(c), 2(d), 3(a), 3(b), 3(c), 3(d), 5 or 6 or demonstrated failures in cooperation arrangements.

Explanatory Note:

The assessor must determine how the jurisdiction's program is designed to use the powers accorded.⁷³ The sufficiency of the powers may depend on the ability to demonstrate that they are exercised effectively. The scope of the investigative and enforcement powers conferred on the regulator and/or on other authorities, including public prosecuting authorities, depends on the conduct under investigation and the legal system applicable in the jurisdiction. The assessor should inquire whether the system, as such, is able effectively to detect, investigate and prosecute violations of the securities laws.

The assessor also should inquire of the regulatory authority as to its view of the adequacy of available sanctioning powers and powers to take corrective action.

Examples of measures used to enforce securities regulatory requirements and to deter and sanction securities violations include: fines; disqualification; suspension and revocation of authority to do business; injunctions or cease and desist orders, directly or through court order; asset freezes, directly or through court order; action against securities

⁷³ Principle 10.

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transactions by unlicensed persons or referral of such activities to the criminal authorities;⁷⁴ measures to enforce disclosure and financial reporting requirements for issuers; measures to enforce conduct of business, capital requirements and other prudential rules; and measures to enforce record keeping and reporting by market intermediaries,⁷⁵ operators of authorized exchanges, regulated trading systems and collective investment schemes, and other regulated securities entities.

Sanctions cited above are exemplary and not necessary to receive a *Fully Implemented* assessment provided that the regulator can demonstrate that there is a spectrum of sanctions available that are proportionate, dissuasive and effective.

⁷⁴ Principles, Section 9.2 and footnote 31.

⁷⁵ An example of a measure to enforce reporting requirements would be the power to require an amended financial report or disclosure statement.

Principle 10 **The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.**

While Principles 8 and 9 are intended to establish the nature and extent of the regulator's powers, Principle 10 is designed to measure how effectively and credibly the regulator exercises these powers. The regulator should be able to demonstrate that an effective and credible use of inspection, surveillance, and enforcement powers has been made and will be made in the future.

In particular, the regulator should be able to demonstrate and explain how its powers are exercised by:

- The regulatory actions undertaken in the jurisdiction and the compliance programs in place.
- The type of on-going and *ad hoc* monitoring activities (including on site inspections) performed in the jurisdiction.
- The investigation and enforcement actions undertaken in the jurisdiction.
- The sanctions imposed with respect to misconduct detected within the jurisdiction.

Key Issues

1. In order to have an effective and credible enforcement system, it is not sufficient for a regulator simply to have the statutory powers set forth in the Principles. The regulator should be able to:
 - a) Detect suspected breaches of the law in an effective and timely manner.
 - b) Gather the relevant information necessary for investigating such potential breaches.
 - c) Be able to use such information to take action where a breach of the law is identified.
2. In addition, the regulator should require a compliance system to be in place for regulated entities aimed at detecting and deterring securities law violations, which includes:

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- a) Inspections using instruments and techniques which are adequate, but which may vary from jurisdiction to jurisdiction.
- b) Other monitoring or surveillance techniques.

Key Questions

Is there evidence of an effective system in place to detect breaches, gather and use information, promote compliance and sanction non-compliance, using surveillance, inspection, investigation, enforcement and intervention powers, as follows:

Detecting Breaches

1. Is there an effective system of inspection in place whereby the regulator carries out inspections?⁷⁶
 - a) On a routine periodic basis?
 - b) Based upon a risk assessment?
 - c) Based upon a complaint associated with an inspected entity?
2. Is there an automatic system which identifies unusual transactions on authorized exchanges and regulated trading systems?
3. Can the regulator demonstrate adequate mechanisms and procedures to detect and investigate:
 - a) Market and/or price manipulation?
 - b) Insider trading?
 - c) Failure of compliance with other regulatory requirements, for example: conduct of business, capital adequacy, disclosure or segregation of client assets?⁷⁷
4. Does the regulator have an adequate system to receive and respond to investor complaints?⁷⁸

Gathering and Using Information

5. Is there evidence, such as inspection reports and follow up action, which indicates that the regulator is competently discharging inspection responsibilities?

⁷⁶ Principles, Section 8.2 ¶s 3 and 4.

⁷⁷ Principles, Section 13.6 and the Multilateral MOU, supra.

⁷⁸ See Explanatory Note.

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6. Is there evidence that the regulator is adequately addressing unusual market activity?

Compliance System

7. Does the regulator require regulated entities to have in place supervisory and compliance procedures reasonably designed to prevent securities laws violations?
8. Does the regulator monitor how compliance procedures are executed and communicated to employees of such entities?
9. Can the regulator take measures against or discipline or sanction intermediaries for failure to supervise reasonably subordinate personnel whose activities violate the securities laws?
10. Does the regulator require market surveillance mechanisms that permit an audit of the execution and trading of all transactions on authorized exchanges and regulated trading systems?⁷⁹
11. Does the regulator or other competent authority have an effective enforcement program in place to enforce regulatory requirements?

Benchmarks

Fully Implemented

Requires affirmative responses to either 1(a) or 1(b) and to all other applicable Questions provided that, in the case of an affirmative response only to 1(b), there must be some means to identify changes in risk priorities or status of firms potentially subject to inspection and the ability to demonstrate effective coverage.

Broadly Implemented

Requires affirmative responses to either 1(a) or 1(b) and to all other applicable Questions, except to Questions 2 and 8 and/or an investigation, surveillance and enforcement system is in place but more resources need to be committed to ensure effective management, adjustments in operation of the system may be necessary, or certain desirable powers (see Principle 8) are necessary to augment the system to make it more effective.

⁷⁹ Assessors must check whether auditing of transactions is provided for and in fact has been performed.

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Partly Implemented

Requires affirmative responses to either Questions 1(a) or 1(b) and to all other applicable Questions except to Questions 2, 4, 8, 9 and 10, and the regulator can demonstrate that it has an active enforcement and compliance program, although there are some deficiencies in timeliness or coverage.

Not Implemented

Inability to respond affirmatively to both Question 1(a) and 1(b) or one or more of Questions 1(c), 3(a), 3(b), 3(c), 5, 6, 7 or 11 or inability to demonstrate commitment of sufficient resources (from the perspective of number and competency) to enforcement efforts and evidence of significant enforcement problems.

Explanatory Note

In assessing this Principle, the assessor also should refer to Principles 8 and 9 with respect to powers, Principles 11 and 13 with respect to cooperation and Principles 2 and 3 with respect to adequacy of resources, procedures and accountability of regulators.

The regulator should identify records and other material evidence that describe enforcement activities including legislative provisions, published guidance, and illustrative press releases covering relevant enforcement cases, complaints and dispositions, if public.

In assessing a risk-based inspection program, the assessor should determine how priorities are set and how they are adjusted or updated, for example, by use of review of periodic financial reports or other mechanisms. It is sufficient that a system for the redress of complaints under the regulatory framework be addressed through an ombudsman, external dispute-resolution provision or other third party scheme or through oversight of individual firm arrangements.

D. Principles Relating to Cooperation

1. Preamble

Fraud, market manipulation, insider trading and other illegal conduct, such as the unauthorized provision of financial services, that crosses jurisdictional boundaries can and does occur more and more frequently in a global market aided by modern telecommunications.

The inability to provide full and timely regulatory assistance can adversely affect efforts towards effective securities regulation. Domestic laws should not impede international cooperation. Effective regulation can be compromised when necessary information is located in another jurisdiction and is not available or accessible.

Principles 11, 12 and 13 deal with the cooperation among regulators and their domestic and foreign counterparts for investigations, enforcement and for other regulatory purposes.⁸⁰ Cooperation is vital in ensuring that investigations and enforcement actions are not impeded unnecessarily by jurisdictional boundaries. Principle 11 measures the extent of a regulator's ability to share information. Principle 12 deals with whether the regulator has mechanisms in place to establish when and how the regulator will share information with its counterparts. Principle 13 relates to the types of assistance that a regulator may provide to a counterpart.

There may be an important need to share information at a domestic level. Where there is more than one regulator or where the securities law overlaps with the general law of a jurisdiction, the need for domestic cooperation may extend beyond matters of enforcement and include information relevant to authorization to act in a particular capacity and to the reduction of systemic risk, for example, where there are divisions in responsibility for the securities, banking and other financial sectors.⁸¹

The importance of international cooperation in investigations and inquiries into possible breach is also apparent from some of the common characteristics of breaches of securities law, such as shifting the proceeds of crime to foreign jurisdictions; wrongdoers fleeing to a foreign country; routing transactions through foreign jurisdictions to disguise the identity of parties or the flow of funds; the use of foreign accounts to hide beneficial

⁸⁰ Principles, footnote 31. Information sharing for other regulatory purposes may require, for example, among other things: routine sharing of information on questionable activities and proven frauds; information on any concern about an applicant in regard to licensing, authorization or eligibility determinations; listing or registration of securities; information about the current circumstances of a license holder or issuer; information that may be needed to minimize the adverse effects of market disruptions, including contingency plans, contact persons and structural measures to address market disruptions; and information on market conditions, such as actions taken by market authorities, prices, trading activities, market data, etc.

⁸¹ Principles 1 and 3.

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ownership of securities; and the facilitation of cross-border breaches through the use of international communications media, including the Internet.

2. *Scope*

The regulator should identify with whom the jurisdiction cooperates, pursuant to what arrangements and for what purposes. For example, in some jurisdictions it may be necessary to obtain information from another authority within the jurisdiction to bring or to initiate an enforcement action. The regulator should be able to demonstrate the gateways or channels through which needed information can be made available and that those channels work when needed. Additionally, the regulator should identify the laws of the jurisdiction, such as blocking, bank secrecy or other types of legislation or judicial decisions, that can affect its ability to cooperate with others.

3. *Principles 11 through 13*

Principle 11 The regulator should have the authority to share both public and non-public information with domestic and foreign counterparts.
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This Principle deals with the power of the regulator(s) to share public and non-public information within its files, or available to it through inspection, *without other external process*. When sharing non-public information, care must be taken by the requested regulatory authority to assure that uses of such information are consistent with the purpose for which it is shared and to preserve its confidentiality subject to such uses.

Key Issues⁸²

1. A regulator should be able to share both public and non-public information with other domestic authorities.
2. A regulator should be able to share public and non-public information with its foreign counterparts.
3. Domestic laws should not impede international cooperation through sharing of information for regulatory, surveillance, technical assistance, or enforcement purposes.

Key Questions

1. For each of the regulators identified,⁸³ does the regulator have authority to share with other *domestic* regulators and authorities information on:
 - a) Matters of investigation and enforcement?
 - b) Determinations in connection with authorization, licensing or approvals?
 - c) Surveillance?
 - d) Market conditions and events?
 - e) Client identification?
 - f) Regulated entities?
 - g) Listed companies and companies that go public?⁸⁴

⁸² Resolution on Recordkeeping, *supra*. See also the Multilateral MOU, *supra*.

⁸³ That is, the regulators which have responsibility for securities enforcement identified as part of the assessment process.

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2. Can the regulator share the information described in Key Question 1 with other *domestic* authorities without the need for external approval⁸⁵ such as from a relevant government minister or attorney?
3. Does the regulator have the authority to share information with *foreign* counterparts with respect to each of the matters listed in Key Question 1, specifically:⁸⁶
 - a) Matters of investigation and enforcement?
 - b) Determinations in connection with authorization, licensing or approvals?
 - c) Surveillance?
 - d) Market conditions and events?
 - e) Client identification?
 - f) Regulated entities?
 - g) Listed companies and companies that go public?
4. Can the regulator share the information for enforcement and regulatory purposes with *foreign* counterparts without the need for external approval,⁸⁷ such as from a relevant government minister or attorney?
5. Can the regulator provide information to other *domestic* and *foreign* authorities on an unsolicited basis?⁸⁸
6. Can the regulator share information with *foreign* counterparts even if the alleged conduct is not such that it would constitute a breach of the laws of the regulator's jurisdiction if conducted within that jurisdiction?⁸⁹

⁸⁴ Principles, Section 9.3 ¶s 4 and 5, Section 9.4, and footnote 42. IOSCO President's Committee, *Resolution on International Equity Offers* (September 1989); IOSCO Public Document No. 86, *Guidance on Information Sharing*, IOSCO Technical Committee (March 1998). See also, Multilateral MOU, *supra*.

⁸⁵ If such approval is purely formalistic and occurs immediately, the regulator could receive a *Fully Implemented* assessment even though such approval is required. For example, in some jurisdictions, the Attorney General or similar official signs off on actions as the chief legal authority in the system. Ideally, in domestic circumstances some sharing would be pre-approved.

⁸⁶ Resolution on Recordkeeping, *supra*. See also the Multilateral MOU, *supra*. This question may be answered in the affirmative if one competent authority has the authority to share all required information, including information originally in the possession of another competent domestic authority, with its foreign counterpart.

⁸⁷ If such approval is purely formalistic and occurs immediately, the regulator could receive a *Fully Implemented* assessment even though such approval is required. See previous example.

⁸⁸ IOSCO Internal Document, *Recommended Practices for Information-Sharing and Cooperation* (October 2002), page 5; Multilateral MOU, *supra*.

⁸⁹ IOSCO Public Document No. 17, *Principles of Memoranda of Understanding*, IOSCO Technical Committee (September 1991); the Multilateral MOU, *supra*.

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7. Where the regulator can obtain information and records identifying the person or persons beneficially owning or controlling bank accounts related to securities and derivatives transactions and brokerage accounts, can the regulator share that information with *domestic* and *foreign* counterparts?⁹⁰

Benchmarks

Fully Implemented

Requires an affirmative response to all applicable Questions.

Broadly Implemented

Requires an affirmative response to all applicable Questions except to Questions 2, 4 and 5, provided that information sharing still can occur in a timely fashion.

Partly Implemented

Requires an affirmative response to all applicable Questions except to Question 3(c) provided that information can be made available in specific cases, Questions 2 and 4 if the conditions for *Broadly Implemented* are not met, and Questions 5 and 7.

Not Implemented

Inability to respond affirmatively to one or more of Questions 1(a), 1(b), 1(c), 1(d), 1(e), 1(f), 1(g), 3(a), 3(b), 3(c), 3(d), 3(e), 3(f), 3(g) or 6, or such a significant inability to act in a timely manner that the Principle cannot be regarded as implemented.

Explanatory Notes

Notwithstanding the obligation to cooperate domestically, when information is passed through an international channel, the uses of such information may be restricted to the uses specified in the information sharing arrangement.

If there are bank secrecy, confidentiality or blocking statutes, the regulator should be able to demonstrate whether there are exceptions to these statutes that allow the regulator to obtain and share information with foreign counterparts.⁹¹ Assessors should ask whether there have been court cases or other developments that cast doubt as to whether the powers granted to the regulator are in fact enforceable.

The Principles recognize that the regulator can legitimately impose conditions when it shares information, particularly non-public information, with its domestic and foreign

⁹⁰ Resolution on Recordkeeping, *supra*. See also the Multilateral MOU, *supra*.

⁹¹ Principles, Section 8.4 ¶2. See also Multilateral MOU, *supra*.

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counterparts. Conditions might include ensuring appropriate use of the information and ensuring the confidentiality of the information except pursuant to the uses permitted, such as in a public enforcement action for which use the information was requested. See also Principle 12, which addresses confidentiality safeguards more generally.

A request for assistance may be denied by a requested authority where a criminal proceeding has already been initiated in the jurisdiction of the requested authority based on the same facts and against the same persons, or where the same persons have already been the subject of final punitive sanctions on the same charges by the competent authorities of the jurisdiction of the requested authority, unless the requesting authority can demonstrate that the relief or sanctions sought in any proceeding initiated by the requesting authority would not be of the same nature or duplication of any relief or sanctions obtained in the jurisdiction of the requested authority.

Principle 12 Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.

Memoranda of Understanding facilitate the process of information exchange by making clear permitted uses, confidentiality arrangements, and other operational procedures between the parties.

Key Issues⁹²

1. Information sharing mechanisms, whether formal or informal, should have several characteristics:
 - a) Identification of the circumstances under which assistance may be sought.
 - b) Identification of the types of information and assistance that can be provided.
 - c) Safeguards of the confidentiality of information transmitted.
 - d) A description of the permitted uses of the information.
2. The design of information-sharing mechanisms should take into account the following factors:
 - a) Which market authority or regulator has access to and is able to provide the information or assistance.
 - b) How such access can be obtained under applicable law.
 - c) Confidentiality and use restrictions under applicable law.
 - d) The form and timing of the assistance or information sharing.
 - e) The applicability of other arrangements, including MOUs, between such authorities for sharing investigative and financial information.
3. Where assistance to another authority is provided through the provision of confidential information gathered by the regulator in the exercise of its functions or powers, particular care must be taken to ensure that the information is provided subject to conditions which, to the extent consistent with the purpose of its release, preserve the confidentiality of that information.

⁹² *Principles of Memoranda of Understanding*, supra. See also Principles, Section 9.4 ¶¶ 3 and 4; and Multilateral MOU, supra.

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Key Questions

1. Does the regulator have the power, by legislation, rules or as a matter of administrative practice, to enter into information-sharing agreements (whether formal or informal) with other *domestic* authorities?
2. Does the regulator have the power, by legislation, rules or as a matter of administrative practice, to enter into information-sharing agreements (whether formal or informal) with *foreign* counterparts?
3. Has the relevant regulator developed information-sharing mechanisms to:
 - a) Facilitate the detection and deterrence of cross-border misconduct?
 - b) Assist in the discharge of licensing and surveillance responsibilities?⁹³
4. Where warranted by the scope of cross-border activity and the ability to provide reciprocal assistance, does the regulator actively try to establish information-sharing arrangements with *foreign* regulators?
5. Are these arrangements documented in writing?
6. Does the regulator take steps to assure safeguards are in place to protect the confidentiality of information transmitted consistent with its uses?⁹⁴
7. Can the regulator demonstrate that it shares information, where appropriate safeguards are in place, when it is requested by another domestic authority or foreign counterpart?

Benchmarks

Fully Implemented

Requires an affirmative response to all applicable Questions.

Broadly Implemented

Requires an affirmative response to all applicable Questions except to Question 5.

Partly Implemented

Requires an affirmative response to all applicable Questions except to Question 5 and that an affirmative response to one or more of Questions 3(a), 3(b) and 4 is not required if the regulator's jurisdiction does not do

⁹³ When the person that is the subject of the inquiry is known to the requested authority.

⁹⁴ *Principles of Memoranda of Understanding*, supra. See also Multilateral MOU, supra.

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substantial cross border business and the need for information sharing is infrequent and *ad hoc*.

Not Implemented

Inability to respond affirmatively to one or more of Questions 1, 2, 6 or 7 or Questions 3(a), 3(b) or 4 if the regulator's jurisdiction does more than an insubstantial cross border business, or there is evidence that information cannot be, and is not being, shared in appropriate cases in a timely manner.

Explanatory Notes

Memoranda of understanding or other documented arrangements can help to add certainty, and in some cases, expedition, to the process of information exchange. Nonetheless, the mere formality of an arrangement is no substitute for a close and cooperative arrangement.

The assessor should be able to provide actual evidence of the use and usefulness of existing arrangements for cooperation. For example, the jurisdiction should be able to demonstrate that it can and does share information when requested to do so by another authority. If this is not possible, then the assessor should question the efficacy of either formal or informal arrangements. The assessment does not address whether the regulator obtains the information directly or indirectly.⁹⁵

⁹⁵ Resolution on Recordkeeping, *supra*. See also the Multilateral MOU, *supra*. This question may be answered in the affirmative if one competent authority has the authority to share all required information, including information originally in the possession of another competent domestic authority, with its foreign counterpart.

Principle 13 **The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers.**

This Principle addresses the ability of the Regulator to compel information or to provide other assistance to a foreign regulator to obtain information that is not contained in the requested Regulator's files.

Key Issues⁹⁶

1. A *domestic* regulator should be able to provide effective assistance to *foreign* regulators who need to make inquiries under their competence, with respect to securities and derivatives matters, including bank and brokerage records and client identification information, regardless of whether the *domestic* regulator has an independent interest in the matter.
2. Assistance, including compulsory assistance, in obtaining records should be provided to *foreign* regulators in securing compliance with securities and derivatives laws.
3. Regulators should be able to provide assistance, including obtaining court orders, to the full extent of their powers.
4. Regulators should be able to provide information on financial conglomerates subject to their supervision.
5. Regulators should be able to provide assistance not only for use in investigations and enforcement matters, but also for other types of inquiries, such as part of a compliance program for the purposes of preventing illicit activities.

Key Questions

1. Is the *domestic* regulator able to offer effective and timely assistance to *foreign* regulators in obtaining?⁹⁷
 - a) Contemporaneous records sufficient to reconstruct all securities and derivatives transactions, including records of all funds and assets

⁹⁶ *Principles of Memoranda of Understanding*, supra. See also Principles, Section 9.4; and Multilateral MOU, supra.

⁹⁷ Resolution on Recordkeeping, supra. See also the Multilateral MOU, supra. This question may be answered in the affirmative if one competent authority has the authority to share all required information, including information originally in the possession of another competent domestic authority, with its foreign counterpart. See also Principle 8.

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- transferred into and out of bank and brokerage accounts relating to those transactions?
- b) Records for securities and derivatives transactions that identify:
 - i) The client:
 - (1) Name of the account holder?
 - (2) Person authorized to transact business?
 - ii) The amount purchased or sold?
 - iii) The time of the transaction?
 - iv) The price of the transaction?
 - v) The individual and the bank or broker and brokerage house that handled the transaction?
 - c) Information located in its jurisdiction identifying persons who beneficially own or control non-natural persons organized in its jurisdiction?⁹⁸
2. Is the *domestic* regulator able to offer effective and timely assistance to *foreign* regulators in securing compliance with laws and regulations related to:
- a) Insider dealing, market manipulation, misrepresentation of material information and other fraudulent or manipulative practices relating to securities and derivatives, including solicitation practices, handling of investor funds and customer orders?
 - b) The registration, issuance, offer, or sale of securities and derivatives, and reporting requirements related thereto?⁹⁹
 - c) Market intermediaries, including investment and trading advisers who are required to be licensed or registered, collective investment schemes, brokers, dealers and transfer agents?¹⁰⁰
 - d) Markets, exchanges and clearing and settlement entities?
3. Is the *domestic* regulator able, according to its domestic laws and regulations, to provide effective and timely assistance to *foreign* regulators regardless of whether the *domestic* regulator has an independent interest in the matter?¹⁰¹

⁹⁸ Principles, Section 9.4 ¶ 8; Resolution on Recordkeeping, *supra*. See also Multilateral MOU, *supra*.

⁹⁹ 1997 Resolution on Recordkeeping, *supra*. See also Multilateral MOU, *supra*.

¹⁰⁰ Principles, Section 9.4 ¶ 8, bullet point 1.

¹⁰¹ Principles, Section 9.4 ¶ 7; *Principles of Memoranda of Understanding*, *supra*; Multilateral MOU, *supra*.

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4. Is the *domestic* regulator able to offer effective and timely assistance to *foreign* regulators in obtaining information on the regulatory processes¹⁰² in its jurisdiction?¹⁰³
5. Is the *domestic* regulator able to offer effective and timely assistance to *foreign* regulators in requiring or requesting:
 - a) The production of documents?
 - b) Taking a person's statement or, where permissible, testimony under oath?¹⁰⁴
6. Is the *domestic* regulator able to offer effective and timely assistance to *foreign* regulators in obtaining court orders, if permitted, for example, urgent injunctions?¹⁰⁵
7. Is the *domestic* regulator able to provide effective and timely assistance to *foreign* regulators regarding information about financial conglomerates subject to its supervision and more precisely assistance in relation, for example, to:
 - a) The structure of financial conglomerates?
 - b) The capital requirements in conglomerate groups?
 - c) Investments in companies within the same group?
 - d) Intra-group exposures and group-wide exposures?
 - e) Relationships with shareholders?
 - f) Management responsibility and the control of regulated entities?¹⁰⁶

Benchmarks

Fully Implemented

Requires an affirmative response to all applicable Questions.

¹⁰² “Regulatory processes” refer to formal processes, such as licensing procedures or audit procedures which could be relevant to enforcement.

¹⁰³ Principles, Section 9.4 ¶s 1 and 8, bullet point 5. See also *Principles of Memoranda of Understanding*, supra. See also Multilateral MOU, supra.

¹⁰⁴ Principles, Section 9.4 ¶ 8, bullet point 4. See also Multilateral MOU, supra.

¹⁰⁵ Principles, Section 9.4 ¶ 8, bullet point 5. The regulator should be able to compel the production of documents.

¹⁰⁶ Principles, Section 9.5 ¶ 2. See also *Principles of Memoranda of Understanding*, supra.

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Broadly Implemented

Requires affirmative responses to all Questions except that in respect to Question 7, the regulator can only provide a few of the types of information listed and this limitation does not affect its ability to provide information on the entity subject to its supervision or oversight, and provided however, that the authority takes steps to provide assistance within its powers and such assistance is not so untimely as to be tantamount to being denied.

Partly Implemented

Requires affirmative responses to all questions except to Questions 1(c), 5(b), 6, 7(a), 7(b), 7(c), 7(d), 7(e) and 7(f), provided, however, that the authority takes steps to provide assistance within its powers and such assistance is not so untimely as to be tantamount to being denied.

Not Implemented

Inability to respond affirmatively to one or more of Questions 1(a), 1(b), 2(a), 2(b), 2(c), 2(d), 3, 4 or 5(a) or assistance does not occur or is so untimely as to be tantamount to being denied.

Explanatory Notes

With respect to injunctions or other remedies, such as asset freezes, where permitted, it is understood that the regulator may need the assistance of another authority. Although the power to assist in obtaining such court orders is not required if not permitted for a *Fully Implemented* rating, where such assistance is in fact permitted, the failure to cooperate could result in a *Partly Implemented* rating.

The regulator should be able to demonstrate the timeliness of assistance or cooperative effort by providing records, logs or other supporting evidence.

Derivatives are specifically identified in this section, because some jurisdictions can share information with respect to securities, but not with respect to certain derivatives transactions. The assessor should make this explicit when this is the case.

In the case where there is not power to provide specific assistance, the assessor also should inquire as to whether the regulator is making efforts to seek further powers or taking other steps to augment its capacity to cooperate.

E. Principles Relating to Issuers

1. Preamble

Principles 14, 15 and 16 are closely interrelated. While Principle 14 focuses primarily on full, timely, and accurate disclosure of financial and non-financial information, these same qualities of disclosure are essential for purposes of Principles 15 and 16. For example, it should be impossible to conclude under Principle 15 that holders of securities are treated in a fair and equitable manner if they are not provided with full, timely and accurate disclosure in connection with the voting decisions and change of control transactions addressed in that Principle. Similarly, it should be impossible to conclude under Principle 16 that accounting and auditing standards are of a high and internationally acceptable quality if full, timely and accurate disclosure is not reflected in the financial statements to which such standards have been applied. It also should be impossible to conclude that audited financial statements required in prospectuses, listing particulars documents, and annual reports reflect full, timely and accurate disclosure under Principles 14 or full disclosure to shareholders under Principle 15, if accounting standards of a high and internationally acceptable quality have not been applied to such financial statements.

As pointed out in the Principles, Section 10.2, regulation of issuers should ensure both investor protection and a fair, orderly and efficient market. To determine whether Principles 14, 15 and 16 are implemented in a manner that achieves these objectives, it is also necessary to consider any inadequacies in a jurisdiction's general legal framework, including other laws that complement securities regulation. Annex 1 indicates the laws, such as the law of contracts and company law, which normally constitute part of the legal framework.

Finally, an assessment of implementation of Principles 14, 15 and 16 is also essential for purposes of assessing implementation of Principle 19 regarding collective investment schemes.

2. Scope

Principles 14, 15 and 16 are intended to apply to issuers making “public offerings” of securities and issuers whose securities are “publicly traded.”¹⁰⁷ In assessing implementation of these Principles, however, the assessor should bear in mind that neither of these terms is defined in the Principles.¹⁰⁸ Accordingly, the universe of issuers and transactions to which these three Principles apply may be expected to vary among jurisdictions. The assessor should not attempt to substitute his or her judgment in lieu of the law of the jurisdiction as to what constitutes a public offering, but should indicate

¹⁰⁷ Principles, Section 10.2.

¹⁰⁸ Principles, Section 10.2 footnote 39.

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what public offerings are covered by the law. This may affect the extent to which these principles are applicable or may point out a regulatory gap.¹⁰⁹

With respect to what constitutes “publicly traded” securities to which the Principles should apply, the Principles relating to Secondary Markets provide useful guidance. These Principles indicate that the concept of a secondary market is not limited to traditional organized exchanges, but is also intended to include various regulated forms of “off-exchange” market systems that trade equity and debt securities, as well as options and certain derivative products. That section, however, is directed principally to authorized exchanges and regulated trading systems as defined therein. Regulation appropriate to a particular secondary market will depend upon the nature of the market and its participants.¹¹⁰

Bearing in mind that Principles 14, 15, and 16 set forth requirements for disclosure and reporting primarily by corporate issuers, that the objective of these Principles is investor protection, and that the objective of authorized exchanges and regulated trading systems is fairness, efficiency and transparency, the assessor should determine the exchanges and trading systems within a jurisdiction that are deemed to be exchanges and trading systems subject to regulation under Principles 25 through 30 and which provide trading services in corporate equity and debt securities for retail investors. Implementation of Principles 14, 15, and 16 should be assessed with respect to issuers whose securities are traded on those authorized exchanges and regulated trading systems.

Even with this guidance, an assessor may have to exercise judgment in assessing whether Principles 14, 15, and 16 have been implemented with respect to publicly traded securities in a particular market. Consider the following example:

Jurisdiction A has an authorized securities exchange, being assessed under Principles 25-30 that has 40 actively traded corporate issues. Two of these issues are listed on the A-Level of the exchange and disclosure and reporting of the issuers complies with the requirements of Principles 14, 15, and 16. However, the remaining 38 issues are listed on the B-Level of the exchange and disclosure and reporting requirements of these issuers fall substantially short of the requirements of Principles 14, 15, and 16. The assessment should be *Not Implemented*.

In assessing implementation of Principles 14, 15, and 16, the assessor also should recognize that the source of disclosure and reporting requirements will not necessarily be limited to securities law and regulations. For example, in some jurisdictions, timely disclosure and other requirements are imposed by marketplace listing rules. In such circumstances, there should be appropriate oversight by the regulator.

Finally, the assessor should determine the extent to which a jurisdiction’s secondary market and publicly traded issues are subject to, or are realistic candidates for, cross-

¹⁰⁹ Principle 1.

¹¹⁰ Principles, Section 13.2.

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border listing and/or trading activity, since this may affect the importance of certain of the Key Questions.¹¹¹

In general, the appropriate framework for issuer regulation includes adequate company, accounting, commercial and contract law. While the assessor should be informed about the legal framework, in general, the specific objectives of non-securities specific law are addressed explicitly in the Key Issues, Key Questions and Benchmarks to this section.

¹¹¹ Principle 14, Key Question 11. See also Principle 15, Key Question 6. See also Principle 16, Key Question 10, *infra*.

3. *Principles 14 through 16*

Principle 14 There should be full, timely and accurate disclosure of financial results and other information that is material to investors' decisions.

This Principle requires consideration of the adequacy, accuracy and timeliness of both financial and non-financial disclosures that are material to investors' decisions. These disclosures may pertain to specified transactions, periodic reports and ongoing disclosure of and reporting of material developments. The disclosure of current and reliable information necessary to make informed investment decisions is directly related to investor protection and to fair, efficient and transparent markets.¹¹² The term "issuer" should be understood broadly to include all those who raise funds on the market.¹¹³

Key Issues

Full Disclosure

1. The regulatory framework should ensure full, timely and accurate disclosure of financial results and other information that is material to investors making informed investment decisions on an ongoing basis.
2. Disclosure rules should extend to:
 - a) The conditions applicable to an offering of securities for public sale.
 - b) The content and distribution of prospectuses, listing particulars documents or other offering documents.
 - c) Supplementary documents prepared in the offering.
 - d) Advertising in connection with the offering of securities.
 - e) Information about those who have a significant interest in a listed company.
 - f) Information about those who seek control of a company.
 - g) Information material to the price, or value, of a listed security.¹¹⁴
 - h) Periodic reports.

¹¹² Principles, Section 10.3.

¹¹³ Principles, Section 10.2 ¶ 2.

¹¹⁴ If there are classes of shares or other structural features that would affect share price, these should be disclosed. This information also would include the release of price sensitive information.

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- i) Shareholder voting decisions.¹¹⁵

General Disclosure

3. Specific disclosure requirements should be augmented by a general disclosure requirement.¹¹⁶

Sufficiency, Accuracy, Timeliness and Accountability for Disclosure

4. Disclosure should be comprehensive, clear, reasonably specific, accurate and timely.
5. Regulation should ensure that proper responsibility is taken for the content of information and, depending on the circumstances, those liable for such disclosures may include the issuers, underwriters, promoters, directors, authorizing officers, experts and advisers who consent to be named in the document.¹¹⁷

Derogations

6. The circumstances under which a derogation from full and timely disclosure is permitted should be limited, and the safeguards that apply in such circumstances should be clear.

Key Questions

Full Disclosure

1. Does the regulatory framework have clear, reasonably timely, comprehensive and specific disclosure requirements that apply to:
 - a) Public offerings, including the conditions applicable to an offering of securities for public sale, the content and distribution of prospectuses and other offering documents (and, where relevant, short form profile or introductory documents) and supplementary documents prepared in the offering?¹¹⁸
 - b) Annual reports?
 - c) Other periodic reports?
 - d) Shareholder voting decisions?

¹¹⁵ Principles, Section 10.4 ¶ 1.

¹¹⁶ Principles, Section 10.4 ¶ 2.

¹¹⁷ Principles, Section 10.4 ¶ 3.

¹¹⁸ The term “conditions” refers to both any restrictions or stipulations with respect to an offer and the transaction terms.

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2. Does the regulatory framework have sufficiently clear, comprehensive and specific requirements that apply to:
 - a) Timely disclosure of events that are material to the price or value of listed securities?¹¹⁹
 - b) Listing of securities?¹²⁰
 - c) Advertising of public offerings outside of the prospectus?¹²¹
3. If there are derivative markets, is there disclosure of the terms of the contracts traded, the mechanics of trading and the risks related to gearing or leverage by market operators or intermediaries?¹²²
4. Does the regulatory framework require:¹²³
 - a) Financial information and other required disclosure in prospectuses, listing documents, annual and other periodic reports, and, where applicable, in connection with shareholder voting decisions, to be of sufficient timeliness to be useful to investors?
 - b) Periodic information about financial position and results of operations (which may be in summary form) to be made publicly available to investors?
 - c) Appropriate measures to be taken (for example, provision of more recent unaudited financial information) when the audited financial statements included in a prospectus for public offerings are stale?¹²⁴

General Disclosure

5. In addition to specific disclosure requirements, is there a general requirement to disclose either all material information or all information necessary to keep the disclosures made from being misleading?¹²⁵

Sufficiency, Accuracy, Timeliness and Accountability for Disclosure

6. Are there measures available to the regulator (e.g., review, certification,¹²⁶ supporting documentation, sanctions) to help assure the sufficiency, accuracy and timeliness of the required disclosures?¹²⁷

¹¹⁹ Principles, Section 10.3 and 10.4 ¶ 2. See also Explanatory Notes regarding timeliness.

¹²⁰ Principles, Section 10.2 ¶s 1 and 2; and Section 10.4 ¶ 1.

¹²¹ Principles, Section 10.2 ¶ 1 and Section 10.4 ¶ 1.

¹²² Principles, Section 10.2 footnote 40.

¹²³ Principles, Sections 10.3 and 10.4 ¶ 2.

¹²⁴ Principle 14, Principles, Sections 10.3; 10.4 ¶ 2; and 10.6 ¶ 2.

¹²⁵ Principles, Section 10.4 2nd ¶.

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7. Does regulation ensure that proper responsibility is taken for the content of information in disclosure documents and the timeliness of disclosure by providing for sanctions or liability of the issuer and those responsible persons who fail to exercise due diligence in the gathering and provision of information? (Depending upon the circumstances, these persons may include the issuer, underwriters, directors, authorizing officers, promoters, and experts and advisers consenting to be named as such.)¹²⁸

Derogations

8. Are the circumstances where disclosures may be omitted or delayed limited to trade secrets, similar proprietary information or other valid business purposes, such as incomplete negotiations?¹²⁹
9. Where there are derogations from the objective of full and timely disclosure, is regulation sufficient to provide for:¹³⁰
- a) Temporary suspensions of trading?
 - b) Restrictions on, or sanctions regarding, the trading activities of persons with superior information?¹³¹

Cross-Border Matters

10. If public offerings or listings by foreign issuers are significant within the jurisdiction, are the jurisdiction's disclosure requirements for such offerings or listings of equity securities by foreign issuers consistent with IOSCO's International Disclosure Standards for Cross-Border Offerings and Initial Listings by Foreign Issuers?¹³²

Benchmarks

Fully Implemented

Requires affirmative responses to all applicable Questions. If there are no derogations to disclosure, then Questions 8, 9(a) and 9(b) can be considered inapplicable.

¹²⁶ "Certification" is generally used in conjunction with internal audits of financial statements; but the list is intended to be exemplary and certification could also refer to other certifications

¹²⁷ Principles, Section 10.4 last ¶.

¹²⁸ Principles, Section 10.4 ¶ 4.

¹²⁹ Id.

¹³⁰ In the case of price sensitive information.

¹³¹ Principles, Section 10.4 ¶ 4.

¹³² IOSCO Public Document No. 81, *International Disclosure Standards for Cross Border Offerings and Initial Listings by Foreign Issuers*, IOSCO (September 1998).

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Broadly Implemented

Requires affirmative responses to all applicable Questions except to Questions 2(c), 4(c) and 8.

Partly Implemented

Requires affirmative responses to all applicable Questions except to Questions 1(c), 2(c), 3, 4(c), 8 and 10.

Not Implemented

Inability to respond affirmatively to one or more of Questions 1(a), 1(b), 1(d), 2(a), 2(b), 4(a), 4(b), 5, 6, 7, 9(a) or 9(b).

Explanatory Notes

With respect to a jurisdiction's disclosure framework, the Key Questions envision that the assessor should take into consideration not only the whether the information required to be disclosed is sufficiently clear, comprehensive, reasonably timely and specific but also whether the disclosure is made available under circumstances that encourage investors to use this information to make investment and voting decisions. For example, the assessor should take into consideration whether the regulatory regime adequately addresses sales practices, such as "touting" or advertising outside of the required disclosure documents that may detract from investors' reliance upon the required disclosure documents.

With respect to what may constitute "timely disclosure" for purposes of Key Question 2(a), the Principles for Ongoing Disclosure and Material Development Reporting by Listed Entities issued by the IOSCO Technical Committee provide:

The listed entity shall disclose ongoing information on a timely basis, which could require disclosure on an:

- (a) immediate basis for disclosure of material developments, where such term could be defined as "as soon as possible" or prescribed as a maximum of specified days (such as 2 business days, as proposed in certain jurisdictions);¹³³

These principles also indicate:

Under the general ongoing obligation approach, disclosure may be subject to delay, to be granted in some jurisdictions by the competent authority, if:

- (a) the information is confidential under legislation;

¹³³ IOSCO Public Document No. 132, *Principles for Ongoing Disclosure and Material Development Reporting by Listed Entities for Foreign Offers*, IOSCO Technical Committee. (October 2002). pp. 4-5.

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- (b) the information concerns an incomplete proposal or negotiations or the disclosure of particular information is such as to prejudice the legitimate interests of the entity's investors; in such cases the listed entity must ensure that the information is maintained strictly confidential.¹³⁴

Finally, in referring to disclosures required on a periodic basis prescribed by law or listing rules, such as quarterly or annual reports, these principles note that “[t]he disclosure obligation may require disclosure of relevant information on an immediate basis even when it belongs to periodic reporting.”¹³⁵

With respect to appropriate delivery of periodic financial information in Key Question 4(b), practices vary among jurisdictions as to the frequency and timing of disclosure of periodic financial information. An affirmative response to Key Question 4(b) is warranted if the periodic financial information is made available on at least a semi-annual basis.

¹³⁴ Id.

¹³⁵ Id.

Principle 15 Holders of securities in a company should be treated in a fair and equitable manner.

This Principle requires an assessment whether the basic rights of shareholders are protected and whether shareholders within a class are treated equitably.

Principle 15 addresses many of the same issues that are covered by Principles I and II of the *Principles of Corporate Governance* of the Organization for Economic Cooperation and Development (OECD) regarding the rights and equitable treatment of shareholders, particularly in connection with voting decisions, takeover bids, and other transactions that may result in a change in control or that may consolidate control.¹³⁶

Generally, the assessor should evaluate the responses to the Key Questions below based upon the jurisdiction's requirements with respect to issuers that are organized or incorporated within the jurisdiction. However, if foreign issuers' public offerings or listings within the jurisdiction are significant, Key Question 6 should be addressed.

Key Issues

Rights of Shareholders

1. The basic rights of equity shareholders are:
 - a) The right to document¹³⁷ and transfer ownership.
 - b) The right to participate on an informed basis in voting decisions (if the securities have voting rights).
 - c) The right to participate equitably in dividends and other distributions, when, as and if declared, including distributions upon liquidation.
 - d) The right to pass upon changes in the terms and conditions of rights attaching to their shares.
 - e) The right, as far as practicable, to have reasonable and equal opportunities to participate in any benefits accruing to the shareholders under any proposal under which a person would acquire a substantial interest in the company.¹³⁸
 - f) The right to hold company management accountable for its actions.

¹³⁶ This could include issuer bids as well as tender offers.

¹³⁷ Register or perfect.

¹³⁸ Principles, Section 10.5 ¶ 4.

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- g) The right to receive fair and equal treatment (in particular, treatment of minority shareholders) in relation to the proposal.¹³⁹

Control

- 2. To safeguard fair and equitable treatment of shareholders, regulation should require disclosure of:
 - a) Changes in controlling interests.
 - b) Information necessary to informed decision-making with respect to tender offers, take-over bids, and other transactions intended to effectuate a change of control or that potentially may result in a change of control, or that may consolidate control.
 - c) Shareholdings of directors and senior management.¹⁴⁰
 - d) Shareholdings of those persons who hold a substantial beneficial ownership interest in a company.¹⁴¹

Key Questions

Rights of Shareholders

- 1. Does the regulatory framework and legal infrastructure address the rights and equitable treatment of shareholders in connection with the following:
 - a) Voting:
 - i) For election of directors?
 - ii) On corporate changes affecting the terms and conditions of their securities?
 - iii) On other fundamental corporate changes?
 - b) Timely notice of shareholder meetings?
 - c) Procedures that enable beneficial owners to give proxies or voting instructions efficiently?
 - d) Ownership registration (in the case of registered shares) and transfer of their shares?
 - e) Receipt of dividends and other distributions, when, as, and if declared?
 - f) Transactions involving:

¹³⁹ Principles, Section 10.5 ¶ 4.

¹⁴⁰ See definition in the Explanatory Notes.

¹⁴¹ Principles, Section 10.1 ¶ 1.

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- i) A takeover bid?
 - ii) Other change of control transactions?
 - g) Holding the company, its directors and senior management accountable for their involvement or oversight resulting in violations of law?
 - h) Bankruptcy or insolvency of the company?¹⁴²
2. Is full disclosure of all information material to an investment or voting decision required in connection with shareholder voting decisions generally and the transactions referred to in Questions 1(f)(i) and 1(f)(ii) specifically?¹⁴³

Control

3. With respect to transactions referred to in Question 1(f)(i) and 1(f)(ii), are shareholders of the class or classes of securities affected by the proposal:
- a) Given a reasonable time in which to consider the proposal?
 - b) Supplied with adequate information to enable them to assess the merits of the proposal?
 - c) As far as practicable, given reasonable and equal opportunities to participate in any benefits accruing to the shareholders under the proposal?
 - d) Given fair and equal treatment (in particular, minority security holders) in relation to the proposal?
 - e) Not unfairly disadvantaged by the treatment and conduct of directors of any party to the transaction or by the failure of the directors to act in good faith in responding to or making recommendations with respect to the proposal?¹⁴⁴
4. With respect to substantial holdings of voting securities:
- a) Is information about the identity and holdings of persons who hold a substantial (well below controlling) beneficial ownership interest in a company required to be timely disclosed:
 - i) In public offering and listing particulars documents?
 - ii) Once the ownership threshold requiring disclosure has been reached?

¹⁴² Principles, Section 10.5 and Principles Annexure 3. This may affect the value of a listed security; shareholders should be able to determine and to exercise their rights in the event of a liquidation or insolvency.

¹⁴³ Principles, Section 10.5.

¹⁴⁴ Id.

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- iii) At least annually (e.g., in the issuer's annual report)?
 - b) Are material changes in such ownership and other required information required to be timely disclosed?
 - c) Are these disclosure requirements applicable to two or more persons acting in concert even though their individual beneficial ownership might not have to be disclosed?
 - d) Is the legal infrastructure sufficient to assure enforcement of, and compliance with, the applicable requirements?¹⁴⁵
5. With respect to holdings of voting securities by directors and senior management:
- a) Is information about the beneficial ownership interest and material changes in beneficial ownership in a company required to be timely disclosed?
 - b) Is such information available:
 - i) In public offering and listing particulars documents?
 - ii) At least annually (e.g., in the issuer's annual report)?
 - c) Is the legal infrastructure sufficient to ensure enforcement of and compliance with these requirements?

Cross Border

6. If public offerings or listings by foreign issuers are significant within the jurisdiction, does the jurisdiction require disclosure in foreign issuers' offering and listing particulars documents of any governance provisions or information relating to the foreign issuer's jurisdiction that may materially affect the fair and equitable treatment of shareholders?¹⁴⁶

Benchmarks

Fully Implemented

Requires affirmative responses to all applicable Questions.

¹⁴⁵ Principles, Section 10.5 ¶s 1 and 2.

¹⁴⁶ *International Disclosure Standards for Cross Border Offerings and Initial Listings by Foreign Issuers*, supra, Part IX A and X A and B.

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Broadly Implemented

Requires affirmative responses to all applicable Questions except to Questions 1(b), 1(c) and 6.

Partly Implemented

Requires affirmative responses to all applicable Questions except to Questions 1(b), 1(c), 1(g), 1(h), 3(e), 4(a)(iii), 4(c), 5(b)(ii) and 6.

Not Implemented

Inability to respond affirmatively to one or more of Questions 1(a)(i), 1(a)(ii), 1(a)(iii), 1(d), 1(e), 1(f)(i), 1(f)(ii), 2, 3(a), 3(b), 3(c), 3(d), 4(a)(i), 4(a)(ii), 4(b), 4(d), 5(a), 5(b)(i) or 5(c).

Explanatory Notes

Concerns regarding the issues treated by this Principle often arise in connection with potentially disparate treatment of majority and minority shareholders, or takeover bids and other change in control transactions where shareholders' rights are affected.

Key Issue 1 sets forth the basic rights of shareholders which should be protected. Corporate governance may be addressed by general law, authorized exchange or regulated trading system listing rules or a code of practice as well as securities laws and regulations.¹⁴⁷

The term “directors and senior management” includes (a) the company's directors, (b) members of the administrative, supervisory and management bodies, (c) partners with unlimited liability, in the case of a limited partnership with share capital, and (d) nominees to serve in any of the aforementioned positions. The persons covered by the term “administrative, supervisory or management bodies” vary in different countries, and for purposes of complying with the disclosure standards, will be determined by the host country.¹⁴⁸

With respect to Key Questions 4(a)(i), 4(a)(ii), 4(a)(iii) and 4(b), practices vary among jurisdictions regarding the threshold that constitutes substantial ownership required to be disclosed (e.g. 5% or 10%) as well as the timeliness (e.g. 7 or 10 calendar or business days) and frequency of disclosure and the thresholds for, and frequency and timeliness of disclosure of, change in substantial ownership. Nevertheless, when such disclosures involve an actual or proposed change in control transaction, it is appropriate to look to the

¹⁴⁷ Principles, footnote 10. See also OECD's *Principles on Corporate Governance*.

¹⁴⁸ *International Disclosure Standards for Cross Border Offerings and Initial Listings for Foreign Offers*, supra. Disclosure of holdings of directors and senior management in a group is sufficient in lieu of disclosure of individual holdings, provided, however, that Key Question 4 would apply regarding separate disclosure of substantial ownership interests of individual directors and senior management.

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Explanatory Notes under Principle 14 for guidance regarding timely disclosure in such circumstances.

With respect to Key Questions 4(a)(i), 4(a)(ii), 4(a)(iii), 5(b)(i) and 5(b)(ii) the timeliness of the ownership disclosure called for obviously will be affected by the timeliness of filing and/or public availability of the document in which the information is included. However, the assessor also should consider whether the ownership information disclosed in such a document is as of a date reasonably close to the date of filing and/or public availability of the document.

Principle 16 Accounting and auditing standards should be of a high and internationally acceptable quality.

Comprehensiveness, consistency, relevance, reliability, and comparability of financial information are crucial to informed decision making.¹⁴⁹

This Principle should be considered and assessed in conjunction with Principle 14, which requires full, timely and accurate disclosure of financial information material to investment decisions. The assessor should establish under Principle 14 whether the financial statements required in public offering and listing particulars documents and periodic reports are sufficient to meet the full, accurate and timely disclosure requirement, and then assess, under Principle 16, the quality of the accounting and auditing standards used in their preparation and verification.

Key Issues

1. High quality, internationally acceptable accounting and auditing standards are essential to ensure the comparability and reliability of financial information for informed decision making. Accounting standards should ensure that fundamental information is disclosed.
2. There should be an appropriate mechanism for the setting and interpretation of high quality accounting and auditing standards.
3. These high quality, internationally acceptable accounting and auditing standards should be enforceable and enforced.
4. The regulatory framework should be designed to assure auditor independence.
 - a) Standards of independence for auditors of listed entities should be designed to promote an environment in which the auditor is free of any influence, interest or relationship that might impair professional judgment or objectivity or, in the view of a reasonable investor, might impair professional judgment or objectivity.
 - b) Standards of independence should identify appropriate safeguards that the auditor should implement in order to mitigate threats to independence that arise from permissible activities and relationships.

¹⁴⁹ Principles, Section 10.6. Financial statements also should show the accountability of management for the resources entrusted to them.

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5. In the case of listed companies, regardless of the particular legal structure in a jurisdiction, a governance body that is in both appearance and fact independent of management of the company being audited (e.g., shareholders or statutory or corporate audit oversight body) should oversee the process of selection and appointment of the external auditor.

Key Questions¹⁵⁰

1. Are public companies required to include audited financial statements in:
 - a) Public offering and listing particulars documents?¹⁵¹
 - b) Publicly available annual reports?
2. Do the required audited financial statements include:
 - a) A balance sheet or statement of financial position?
 - b) A statement of the results of operations?
 - c) A statement of cash flow?
 - d) A statement of changes in ownership equity or comparable information included elsewhere in the audited financial statements or footnotes?¹⁵²
3. With respect to the financial statements required in public offering and listing particulars documents and publicly available annual reports:
 - a) Are these required to be prepared and presented in accordance with a comprehensive body of accounting standards?
 - b) Are these accounting standards of a high and internationally acceptable quality?
4. Are the financial statements presented under circumstances so that they:
 - a) Are comprehensive?¹⁵³
 - b) Are understandable by investors?
 - c) Reflect consistent application of accounting standards?
 - d) Are comparable if more than one accounting period is presented?

¹⁵⁰ Principles, Section 10.6.

¹⁵¹ There may be some circumstances, e.g., in a CIS that has not yet raised funds and an offering of a securitized product, where financial statements are unnecessary. In such circumstances, the regulator may require other information deemed relevant to the terms of such offerings.

¹⁵² Principles, Section 10.6 ¶ 1.

¹⁵³ See Explanatory Notes.

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5. With respect to the audited financial statements included in public offering and listing particulars documents and publicly available annual reports:
 - a) Are these required to be audited in accordance with a comprehensive body of auditing standards?
 - b) Are these auditing standards of a high and internationally acceptable quality?
6. Are there standards or requirements sufficient to ensure that the external auditor is independent?
7. Where unaudited financial statements are used, for example, in interim reports, and interim period financial statements in public offering and listing particulars documents, in full or summary format, is the financial information presented in accordance with accounting standards that are of a high and internationally acceptable quality?
8. In regard to oversight, interpretation and independence:
 - a) With respect to accounting standards:
 - i) Does the regulatory framework provide for an organization responsible for the establishment and timely interpretation of accounting standards?
 - ii) If yes, are the organization's processes open and transparent, and, if the organization is independent, is the interpretation process undertaken in cooperation with, or subject to oversight by, the regulator or another body that acts in the public interest?
 - b) With respect to auditing standards:
 - i) Does the regulatory framework provide for an organization responsible for the establishment and timely interpretation of auditing standards?
 - ii) If yes, are the organization's processes open and transparent, and, if the organization is independent, is the interpretation process undertaken in cooperation with, or subject to oversight by, the regulator or another body that acts in the public interest?
 - c) With respect to the external auditor, in the case of listed companies:
 - i) Is the external auditor required to be independent in both fact and appearance of the company being audited?
 - ii) Is there a governance body independent in both fact and appearance of the management of the company (e.g., shareholders or a statutory or

PRINCIPLES RELATING TO ISSUERS

corporate audit oversight body) that oversees the process of selection and appointment of the external auditor?¹⁵⁴

iii) Is prompt disclosure of information about the resignation, removal or replacement of an external auditor required?

9. Is there an adequate mechanism in place for:
- a) Enforcing compliance with accounting standards such as requiring restatements of financial statements that deviate from accepted standards?
 - b) Enforcing compliance with auditing and auditor independence standards, such as refusal to accept, or requiring revision of, audit reports that deviate from required standards as to the opinion expressed or scope of the audit, or for lack of independence?
10. If public offerings or listings by foreign issuers are significant within the jurisdiction, does the regulator permit the use of high quality, internationally acceptable accounting standards by foreign companies that wish to list or offer securities in the country?¹⁵⁵

Benchmarks

Fully Implemented

Requires affirmative responses to all applicable Questions.

Broadly Implemented

Requires affirmative responses to all applicable Questions except to Questions 8(a)(ii), 8(b)(ii), 8(c)(iii) and 10.

Partly Implemented

Requires affirmative responses to all applicable Questions except to Questions 2(c), 2(d), 3(b), 4(d), 5(b), 7, 8(a)(ii), 8(b)(ii), 8(c)(iii) and 10.

¹⁵⁴ Principle 15, Key Issue 5, *supra*. See also Explanatory Notes.

¹⁵⁵ Principles, Section 10.6 for all Questions, and also discussion under Principle 14 regarding timeliness and full disclosure of financial information material to investment decisions and shareholder voting decisions. See also the IOSCO President's Committee's *Resolution Concerning International Standards on Auditing* (The implementation of this resolution has been suspended because the international standards in auditing to which it referred in October 1992 no longer exist. However, it has not been abrogated because discussions with IFAC are continuing and a possibility remains that this matter can be resolved in the foreseeable future) and the IOSCO Presidents' Committee's *Resolution on IASC Standards* (May 2000).

Not Implemented

Inability to respond affirmatively to one or more of Questions 1(a), 1(b), 2(a), 2(b), 3(a), 4(a), 4(b), 4(c), 5(a), 6, 8(a)(i), 8(b)(i), 8(c)(i), 8(c)(ii), 9(a) or 9(b).

Explanatory Notes

In order to be considered comprehensive for purposes of Key Question 4(a), the accounting standards under which annual financial statements are prepared should require footnotes that (a) summarize the significant accounting policies used in preparing the financial statements, (b) include all material information required to be disclosed by such standards, and (c) include any additional material information necessary to understand the information presented in the body of the financial statements.¹⁵⁶ The assessor should determine what is used in practice and whether and how any standards are enforced.

The accounting, auditing and independence standards referred to under Key Question 6 and parts of Key Question 8 need not be standards that are established or interpreted by an organization within the jurisdiction. Some jurisdictions may wish to adopt and rely upon standards established and/or interpreted by international or other standards-setting organizations. In such circumstances, however, it is essential that a jurisdiction have a regulatory framework in place that provides a mechanism to ensure effective implementation and enforcement of these standards. A jurisdiction's implementation and enforcement mechanisms, including the mechanisms called for by Key Questions 9(a) and 9(b), need not rely upon the regulator or other enforcement authorities organized within the jurisdiction; however, if third party enforcement is utilized, it is essential that the regulatory framework within the jurisdiction provides that the regulator or another body that acts in the public interest is capable of overseeing the enforcement process and ensuring that the process is binding upon companies whose securities are publicly offered or publicly traded within the jurisdiction, and external auditors practicing within the jurisdiction.

Standards of external auditor independence contemplated by Key Questions 6 and 8(c)(i) should include a framework of principles, supported by a combination of prohibitions, restrictions, other policies and procedures and disclosures, that addresses at least the following threats to independence: self-interest, self-review, advocacy, familiarity and intimidation. Independence should include the need to ensure appropriate rotation of the auditor or the audit engagement team, such that senior members of a team do not remain in key decision-making positions for an extended period.¹⁵⁷

With respect to Key Questions 6, 8(c)(ii) and 9(b), effective oversight of external auditors should include mechanisms to: (a) require that the auditors have proper qualifications and

¹⁵⁶ See IOSCO Public Document No. 141, *General Principles Regarding Disclosure of Managements Discussion and Analysis of Financial Condition and Results of Operations*, IOSCO Technical Committee (February 2003).

¹⁵⁷ IOSCO Public Document No. 133, *Principles of Auditor Independence and the Role of Corporate Governance in Monitoring an Auditor's Independence*, IOSCO Technical Committee (October 2002).

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competency before being licensed to perform audits; (b) withdraw authorization to perform audits if proper qualifications and competency are not maintained; (c) require that auditors are independent of the enterprises they audit, both in fact and in appearance; and (d) provide oversight over the quality of auditing, independence and ethical standards, as well as quality control requirements.¹⁵⁸

¹⁵⁸ IOSCO Public Document No. 134, *Principles for Auditor Oversight*, IOSCO Technical Committee (October 2002).

F. Principles Relating to Collective Investment Schemes

1. Preamble

Collective Investment Schemes (CIS) play an important role in modern economies, channeling resources to the securities markets and offering investors a means to achieve diversified exposure to investment opportunities. To the extent that investors place their money in mutual funds and other collective investment vehicles, appropriate regulation is increasingly important.

Proper regulation of CIS is critical to the objectives of investor protection and the preservation of confidence in the market. CIS, like other entities raising funds on the market, are subject to disclosure requirements.¹⁵⁹ However, retail investors in CIS rely upon operators of the schemes to manage their funds and to act in their best interest. Retail investors are particularly vulnerable to misconduct by CIS operators. Regulation should promote and ensure a high level of compliance by entities involved in CIS operations.

Regulation should cover the competence of the fund manager; adherence to the terms of the prospectus and other constituent documents; the proper control of investors' funds and the assets of the scheme, but not the wisdom of investment decisions (where these are within the terms of the constituent documents).

Supervision should seek to ensure that the assets of a CIS are managed in the best interests of its investors and in accordance with the objectives of a CIS. This will include ensuring the assets are held in safekeeping on behalf of investors and having mechanisms in place to confirm that the investments in a CIS are valued properly. Supervision of an operator in this regard includes oversight of arrangements to ensure that investors are exposed to a level of risk that is consistent with the fund's objectives, as well as to ensure that any regulatory minimum level of diversification is maintained.¹⁶⁰

2. Scope

Principles 17 to 20 deal specifically with CIS.

Principle 17 requires regulation to set standards for those involved in the operation of a CIS and marketing CIS interests; Principle 18 is mainly devoted to client assets protection; Principle 19 addresses CIS focused-disclosure requirements, while Principle 20 deals with the issues of asset valuation and pricing and redemption of units.

The above Principles are interrelated and complement each other. All of them have to be implemented in order to ensure proper investor protection. In addition, assessment under

¹⁵⁹ Principles 14 to 16 and Principle 19.

¹⁶⁰ IOSCO Public Document No. 69, *Principles for the Supervision of Operators of Collective Investment Schemes*, IOSCO Technical Committee (September 1997).

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Principle 19, dealing with disclosure, should be consistent with, and/or compared to, the assessment of disclosure obligations as set forth under the Principles for issuers.¹⁶¹

The term “CIS” includes authorized open-ended funds that will redeem their units or shares (whether on a continuous basis or periodically). It also includes closed-ended funds whose shares or units are traded in securities markets, unit investment trusts, contractual models and the European UCITS (Undertakings for Collective Investment in Transferable Securities) model.¹⁶²

In some jurisdictions, closed-ended funds are not subject to special licensing or supervisory requirements and are, instead, regulated according to the terms of relevant exchange listing rules.¹⁶³ If this is the case in the assessed jurisdiction, the situation should be duly accounted for, and detailed explanation, and assessment, of the listing rules applicable should be described taking into account the investor protection objectives of the Key Issues in this section.

In many jurisdictions, the requirements relating to CIS vary according to whether the CIS is offered to the public. In fact, most jurisdictions tend to reduce regulatory oversight in relation to private placements. The definition of what amounts to an offer to the public varies. The assessor should not attempt to substitute his or her judgment for what constitutes a public offering but should indicate which offerings are included and subject to the full panoply of requirements and how regulatory oversight is different for private placements or non-retail offerings. The assessor should explain the differences in treatment and assess the consequences from an investor protection viewpoint, investor protection being the main objective of the CIS Principles.

An increasing number of schemes are marketed across jurisdictional boundaries. It is also common for scheme promoters, managers and custodians to be located in several different jurisdictions and not the same jurisdiction as investors to whom the scheme is promoted.¹⁶⁴ Therefore, particular attention should be paid to the possible need for international cooperation and the interrelation with Principles 11, 12, and 13 relating to cooperation.

The assessor should determine the type and complexity of CIS in the jurisdiction, the number of funds in existence and the types of permitted investments and level of gearing or leverage. It is possible that a specific jurisdiction will not have its own framework for the establishment of collective investment schemes. If a jurisdiction does not have its own CIS regulatory framework, it may not wish to admit offerings that do not meet the basic requirements as to legal format in these Principles.¹⁶⁵ To the extent CIS established

¹⁶¹ Principles 14 to 16.

¹⁶² Principles, Section 11.2 ¶ 1.

¹⁶³ Principles, Section 11.2 footnote 49

¹⁶⁴ Principles, Section 11.10. See also Disclosures under Section E, Principles Relating to Issuers, in the Preamble.

¹⁶⁵ Principle 17.

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under other jurisdictions' laws, however, may be sold, the assessor should consider whether:

- The entity engaged in marketing should be authorized, recognized or otherwise eligible (Principle 17);
- There are requirements concerning the public offer of CIS products (Principles 17, 19 and 20);
- There is adequate information sharing between the jurisdictions of establishment and the jurisdiction being assessed.

The greater the level of CIS activity in a particular jurisdiction, the more likely it is that the principle (Principles 17 through 20) should be rated as *Not Implemented* rather than *Not Applicable* if no requirements are applied to cross-border business.

Securities law and regulation cannot exist in isolation from the other laws of a jurisdiction. Matters of particular importance to the legal framework in general are set out in Book II, Annex 1, from Annexure 3 of the Principles. To determine whether Principles 17, 18, 19 and 20 are implemented in a manner that achieves their objectives, it is therefore necessary to consider the jurisdiction's legal framework in that regard and, in particular, laws and regulations on insolvency (having an impact on the treatment of CIS in default) as well as those rules on dispute resolution mechanisms or other remedies (having an impact on investors' ability to seek redress or compensation).

3. *Principles 17 through 20*

<p>Principle 17 The regulatory system should set standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme.</p>

Eligibility criteria for operators of collective investment schemes ensure that those who operate or market CIS are qualified to do so. This includes being experienced and competent to operate or advise on the suitability of a CIS, and having adequate resources and processes in place to ensure ongoing compliance.

Key Issues

Entry Criteria

1. There should be clear criteria for the eligibility¹⁶⁶ to operate and/or market a collective investment scheme.
2. The approval of CIS should have regard to the possible need for international cooperation.

Supervision and Ongoing Monitoring

3. Records of the operation of the CIS should be maintained.
4. The regulatory system should require a proper supervisory system throughout the life of a particular CIS.
5. There should be clear powers to allow action in respect of all supervised entities with responsibilities under the CIS.
6. Supervision should promote high standards of competence, integrity and fair dealing.

Conflicts of Interest

7. Operators should not benefit to the unfair disadvantage of investors in a CIS.
8. Regulation should ensure that the possibility of conflicts of interest arising is minimized and that any conflicts that do arise are properly disclosed.

¹⁶⁶ The term “eligibility” is intended to include authorization, licensing, registration or other preconditions to operating or marketing a CIS.

Delegation

9. The use of delegates should not, in any way, be permitted to diminish the effectiveness of the primary regulation of a CIS.
10. A delegate should be accountable either directly or through the delegator for compliance with all regulatory requirements applicable to the conduct of the principal's business activities.¹⁶⁷

Key Questions

Entry Criteria

1. Does the regulatory framework set standards for the eligibility and the regulation for those who wish to:
 - a) Market a CIS?¹⁶⁸
 - b) Operate a CIS?¹⁶⁹
2. Do the eligibility criteria for CIS¹⁷⁰ include the following:
 - a) Honesty and integrity of the operator?
 - b) Competence to carry out the functions and duties of the operator (i.e. human and technical resources)?
 - c) Financial capacity?
 - d) Operator specific powers and duties?
 - e) Adequacy of internal management procedures?¹⁷¹
3. Does the approval of schemes take into account the possible need for international cooperation in the case of CIS marketed across jurisdictions or where promoters, managers or custodians are located in several different jurisdictions?¹⁷²
4. Are there:

¹⁶⁷ IOSCO Public Document No. 113, *Delegation of Functions*, IOSCO Technical Committee. (December 2000).

¹⁶⁸ With respect to market intermediaries that may be involved in marketing or operating a CIS, such as brokers, dealers and investment advisors, see also Principles 21 to 24 on Market Intermediaries regarding approaches to regulation of such intermediaries.

¹⁶⁹ Principle 17, Principles, Sections 11.1, 11.2, 11.3, 11.4 and 11.5.

¹⁷⁰ Includes the operator and/or the pool.

¹⁷¹ Principles, Sections 11.3, 11.4, and 11.5.

¹⁷² Principles, Section 11.10.

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- a) Effective, proportionate and dissuasive sanctions for unlicensed operation of a CIS and/or for violation of CIS operator obligations?
- b) Are these sanctions consistently applied?¹⁷³

Supervision and Ongoing Monitoring

5. Is the regulator responsible for ensuring compliance with the eligibility standard? In particular, does the regulatory framework provide for attribution to the regulatory authority of responsibilities and clear powers with respect to:
 - a) Registration or authorization of a CIS?
 - b) Inspections to ensure compliance by CIS operators?
 - c) Investigation of suspected breaches?
 - d) Remedial action in the event of breach or default?¹⁷⁴
6. Is there ongoing monitoring of the conduct of CIS operators throughout the life of a scheme, including continued compliance with eligibility, licensing, registration, or authorization requirements?¹⁷⁵
7. Does the ongoing monitoring involve review of reports to the regulator submitted by CIS (CIS operators, custodians, etc.) on a routine basis?¹⁷⁶
8. Does the ongoing monitoring normally involve performance of on-site inspections of entities involved in operating CIS (CIS operators, custodians, etc.)?¹⁷⁷
9. Do the regulatory authorities proactively perform investigative activities¹⁷⁸ in order to identify suspected breaches with respect to entities involved in the operation of a CIS?¹⁷⁹
10. Is the operator of a CIS subject to a general and continuing obligation to report to the regulatory authority or investors, either prior to or after the event, any information relating to material changes in its management, organization or by-laws?¹⁸⁰

¹⁷³ Principles, Section 11.4.

¹⁷⁴ Principles, Sections 11.4, 8.2, and 8.3.

¹⁷⁵ Principles, Section 11.4.

¹⁷⁶ Principles, Sections 11.4, 8.2, and 8.3. For example, financial results.

¹⁷⁷ Id.

¹⁷⁸ This means activities not prompted by complaint such as risk-based or periodic inspections, audits or surveillance.

¹⁷⁹ Id.

¹⁸⁰ Principles, Sections 11.3 and 11.4.

11. Does the regulatory system assign clear responsibilities for maintaining records of the operations of the scheme?¹⁸¹

Conflicts of Interest

12. Are there provisions to prohibit, restrict or disclose certain conduct likely to give rise to conflicts of interest between a CIS and its operators or their associates or connected parties?¹⁸²
13. Are there regulatory provisions aiming at minimizing conflict of interest situations, to ensure that any conflicts that do arise do not adversely affect the interests of investors?¹⁸³
14. Is the CIS required to comply with rules related to:
- a) Best execution?
 - b) Appropriate trading and timely allocation of transactions?
 - c) Churning?
 - d) Related party transactions?
 - e) Underwriting arrangements?¹⁸⁴

Delegation

15. Does the regulatory system provide for clear indication of circumstances under which delegation is allowed and is there prohibition of systematic and complete delegation of core functions of the CIS operator to the extent that there is a transformation, gradual or otherwise, into an empty box?¹⁸⁵
16. If delegation is permitted, is the delegation done in such a way so as not to deprive the investor of the means of identifying the company legally responsible for the delegated functions? In particular:
- a) Is the CIS operator responsible for the actions or omissions, as though they were its own, of any party to whom it delegates a function?

¹⁸¹ Id.

¹⁸² Principles, Sections 11.3 and 11.4 footnote 51. See also IOSCO Public Document No. 108, *Conflicts of Interests of CIS Operators*, IOSCO Technical Committee (May 2000).

¹⁸³ Principles, Sections 11.3 and 11.4 footnote 51. See also *Conflict of Interests of CIS Operators*, supra.

¹⁸⁴ Principles, Sections 11.3 and 11.4.

¹⁸⁵ Principles, Sections 11.3 and 11.4 footnote 52. See also *Delegation of Functions*, supra.

PRINCIPLES RELATING TO COLLECTIVE INVESTMENT SCHEMES

- b) Does the regulatory system require the CIS operator to retain adequate capacity and resources and have in place suitable processes to monitor the activity of the delegate and evaluate the performance of the delegate?¹⁸⁶
- c) Can the CIS operator terminate the delegation and make alternative arrangements for the performance of the delegated function where appropriate?¹⁸⁷
- d) Are there requirements for disclosure to investors in relation to the delegation arrangements and the identity of the delegates?¹⁸⁸
- e) Does the regulatory system address delegations which may give rise to a conflict of interest between the delegate and the investors?¹⁸⁹

Benchmarks

Fully Implemented

Requires an affirmative response to all applicable Questions.

Broadly Implemented

Requires affirmative responses to all applicable Questions except to Questions 2(c), 9, 16(d) and 16(e).

Partly Implemented

Requires affirmative responses to all applicable Questions except to Questions 2(c), 3, 7, 8, 9, 10, 14(a), 14(b), 14(c), 14(d), 14(e), 15, 16(d), 16(e) and either Question 12 or 13.

Not Implemented

Inability to respond affirmatively to one or more of Questions 1(a), 1(b), 2(a), 2(b), 2(d), 2(e), 4(a), 4(b), 5(a), 5(b), 5(c), 5(d), 6, 11, 16(a), 16(b) or 16(c) and to both Questions 12 and 13.

Explanatory Notes

Consideration should be given to the ability of the regulator to perform ongoing supervision and to take action in respect of all supervised entities with responsibilities under the scheme for enforcement purposes and, more broadly, to ensure that the

¹⁸⁶ The degree of monitoring would depend on the extent of the delegation, to whom the delegation was made (e.g. to authorized intermediaries or to others) and the type of jurisdiction in which the delegate is located.

¹⁸⁷ Principles, Sections 11.3 and 11.4 footnote 52; *Delegation of Functions*, supra.

¹⁸⁸ Id.

¹⁸⁹ Id.

PRINCIPLES RELATING TO COLLECTIVE INVESTMENT SCHEMES

objectives of regulation are attained. To this end, where appropriate, the assessor should make reference to the assessment of Principles 8, 9 and 10.

Attention should also be paid to the international features of the CIS business of the assessed jurisdiction. According to the Principles, these elements should not hinder proper supervision and the need for possible international cooperation should be duly taken into account by assessors; where appropriate, cross reference to the assessment of international cooperation Principles 11, 12 and 13¹⁹⁰ should be made.

¹⁹⁰ In particular, as discussed under Principles, Section 9.3, see also the Preamble to this Section on CIS.

Principle 18 The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.

The legal form and structure of collective investment schemes varies among jurisdictions but is important to the protection of investors as the structure affects the interests and rights of the participants in the scheme and enables the pool of investors' funds to be distinguished and segregated from the assets of other entities and of the operator.

Key Issues

Legal Form/Investors' Rights

1. The regulatory system should address the legal form of CIS and the nature of the rights and interests of investors. Appropriate disclosure of such form and rights should be provided to investors. Such rights should not be left to the discretion of the CIS operator.

*Separation of Assets/Safekeeping*¹⁹¹

2. The pool of investors' funds should be distinguished and segregated from the assets of other entities.
3. Effective mechanisms should be in place to protect client assets from the risk of loss and insolvency of the operator.
4. The risk of default or breach associated with the legal form and structure chosen for a given CIS should be disclosed to investors.
5. The regulatory framework should ensure that the above risks to investors are duly addressed through statutes, rules or mandatory arrangements.

Key Questions

Legal Form/Investors' Rights

1. Does the regulatory framework provide for requirements as to the legal form and structure of CIS that delineate the interests of participants and their related rights?¹⁹²
2. Does the regulatory framework provide that the legal form and structure of a CIS, as well as the implications thereof for the nature of risks associated with the

¹⁹¹ *Principles for Supervision of Operators of Collective Investment Schemes Operators*, supra.

¹⁹² Principle 18, Principles, Sections 11.1 and 11.5.

PRINCIPLES RELATING TO COLLECTIVE INVESTMENT SCHEMES

- scheme, be disclosed to investors in such a way that they are not dependent upon the discretion of the CIS operator?¹⁹³
3. Is there a regulatory authority responsible for ensuring that the form and structure requirements are observed and evidence that the above requirements are enforced in the assessed jurisdiction?¹⁹⁴
 4. Does the regulatory framework provide that where changes are made to investor rights that do not require prior approval from investors, notice is given to them before the changes take effect?¹⁹⁵
 5. Does the regulatory framework provide that where changes are made to investor rights, notice is given to the relevant regulatory authority?¹⁹⁶

Separation of Assets/Safekeeping

6. Does the regulatory framework require the separation and segregation of CIS assets from the assets of the CIS operator and its managers?¹⁹⁷
7. Does the regulatory framework provide for requirements governing the safekeeping of CIS assets such as:
 - a) The obligation to entrust the assets to an independent third party; or
 - b) Special legal or regulatory safeguards in cases where custodial functions are performed by the same legal entity responsible for investment functions (or related entities)?¹⁹⁸
8. Does the regulatory framework provide for the keeping of books and records in relation to transactions involving CIS assets and all transactions in CIS shares or units or interests?¹⁹⁹
9. Does the regulatory framework adequately provide for audit requirements (internal or external) in relation to the assets of a CIS?²⁰⁰

¹⁹³ Principles, Section 11.5.

¹⁹⁴ Id.

¹⁹⁵ Id.

¹⁹⁶ Id.

¹⁹⁷ Principle 18, Principles, Sections 11.1, 11.5, footnote 53, and 11.7, footnote 59, IOSCO Public Document No. 60, *Guidance on Custody Arrangements for Collective Investment Schemes*, IOSCO Technical Committee (September 1996); IOSCO Public Document No. 57, *Client Asset Protection*, IOSCO Technical Committee (August 1996).

¹⁹⁸ Principle 18, Principles, Sections 11.1, 11.5 footnote 53, and 11.7 footnote 59; *Guidance on Custody Arrangements for CIS*, supra; *Client Asset Protection*, supra.

¹⁹⁹ Principles, Sections 11.4 and 11.5.

²⁰⁰ Principles, Sections 11.4 and 11.5 footnote 53. See also *Guidance on Custody Arrangements for CIS*, supra.

10. Does the regulatory framework adequately provide for an orderly winding up of CIS business, if needed?

Benchmarks

Fully Implemented

Requires affirmative responses to all applicable Questions.

Broadly Implemented

Requires affirmative responses to all applicable Questions except to Question 4.

Partly Implemented

Requires affirmative responses to all applicable Questions except to Questions 4, 5 and 10.

Not Implemented

Inability to respond affirmatively to one or more of Questions 1, 2, 3, 6, 7(a), 7(b), 8 or 9.

Explanatory Notes

In evaluating safekeeping, consideration should be given by an assessor to whether the supervisory system in the assessed jurisdiction is capable of ensuring that all CIS investments, including cash deposits, are properly held in safekeeping.

Consideration also should be given to the ability of the system to ensure that the risks of default or breach associated with the scheme are properly addressed. It is important that the interests of CIS investors are duly protected not only while the CIS is a going concern, but also when its continuity is affected by circumstances which require it to be wound up.

The assessor should verify that the regulatory system requires the rights of investors in CIS, or impediments to investors exercising their rights, to be clearly spelled out. The Principles do not comprehensively address collective investment arrangements involving derivatives, many of which are privately offered.

Principle 19 Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.

This Principle aims at ensuring that matters material to the value of a collective investment scheme are the subject of disclosure to investors and potential investors in order to assist investors in understanding the nature of the investment vehicle and the relationship between risk and return.

Key Issues

1. Disclosure should assist investors in understanding the nature of the investment vehicle and the relationship between risk and return.
2. All matters material to an evaluation of the scheme and the value of an investor's interest should be disclosed to investors and potential investors.
3. Information should be provided on a timely basis and in an easy to understand format, having regard to the type of investor.
4. There should be clear disclosure of investment policies.
5. Supervision should ensure that the stated investment policy or trading strategy, or any policy required by regulation, has been followed and that any restrictions on type or level of investment have been complied with.

Key Questions

1. Does the regulatory framework require that all matters material to an evaluation of a CIS and the value of an investor's interest are disclosed to investors, and potential investors, in an easy to understand format?²⁰¹
2. Does the regulatory framework include a general disclosure obligation to allow investors, and potential investors, to evaluate the suitability of the CIS for that investor or potential investor?²⁰²
3. Does the regulatory framework specifically require that the offering documents, or other publicly available information, include the following:

²⁰¹ Principle 19; Principles, Sections 11.1, 11.6 footnote 56; IOSCO Public Document No. 59, *Disclosure of Risk*, IOSCO Technical Committee (September 1996); and IOSCO Public Document No. 130, *Performance Presentation Standards for Collective Investment Schemes*, IOSCO Technical Committee (July 2002).

²⁰² Principle 19; Principles, Sections 11.1, 11.6 and 10.4.

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- a) The date of issuance of the offering document?
 - b) Information concerning the legal constitution of the CIS?
 - c) The rights of investors in the CIS?
 - d) Information on the operator and its principals?
 - e) Information on the methodology of asset valuation?
 - f) Procedures for purchase, redemption and pricing of units?
 - g) Relevant, audited financial information concerning the CIS?
 - h) Information on the custodian (if any)?
 - i) The investment policy(ies) of the CIS?
 - j) Information on the risks involved in achieving the investment objectives?
 - k) The appointment of any external administrator or investment managers or advisers who have a significant and independent role in relation to the CIS (including delegates)?
 - l) Fees and charges in relation to the CIS?²⁰³
4. Does the regulatory authority have the power to hold back, or intervene, in an offering? For example, are there regulatory actions available in the event that the information is inaccurate, misleading or false, or does not satisfy the filing/approval requirements?²⁰⁴
 5. Does the regulatory framework cover advertising material outside of the offering documents, in particular does it prohibit false or misleading advertising?²⁰⁵
 6. Does the regulatory framework require that the offering documents be kept up to date to take account of any material changes affecting the CIS?²⁰⁶
 7. Does the regulatory framework require a report to be prepared in respect of a CIS's activities either on an annual, semi-annual or other periodic basis?²⁰⁷
 8. Does the regulatory framework require the timely distribution of periodic reports?²⁰⁸

²⁰³ Principles 19 and 20. See also Principles, Sections 11.1, 11.5, 11.6, 11.8, 11.9 and 10.4.

²⁰⁴ Principles, Sections 11.4 and 10.4.

²⁰⁵ Principle 19, Principles, Sections 11.1, 11.6, 10.2 and 10.4.

²⁰⁶ Id.

²⁰⁷ Id.

²⁰⁸ Principle 19, Principles, Sections 11.1, 11.6, 10.2 and 10.4. See also Explanatory Note.

9. Does the regulatory framework require that the accounts of a CIS be prepared in accordance with high quality, internationally acceptable accounting standards?²⁰⁹

Benchmarks

Fully Implemented

Requires affirmative responses to all applicable Questions.

Broadly Implemented

Requires affirmative responses to all applicable Questions except to Questions 5 and 8.

Partly Implemented

Requires affirmative responses to all applicable Questions except to Questions 3(b), 3(h), 5, 8 and 9.

Not Implemented.

Inability to respond affirmatively to one or more of Questions 1, 2, 3(a), 3(c), 3(d), 3(e), 3(f), 3(g), 3(i), 3(j), 3(k), 3(l), 4, 6 or 7.

Explanatory Notes

The assessor should cross reference to assessment under Principles 14 to 16 as appropriate. CIS normally target retail investors; therefore, particular attention should be paid to assure the regulatory framework is structured to prevent investors being misled by inappropriate presentation of elements such as risks associated with the investment policies and trading strategies of the scheme, reference to past performance, and fees and other charges that may be levied under the scheme. The information should be provided in an easy to understand format. Proper consideration should be given by the assessor to the retail nature of CIS business.

²⁰⁹ Principle 19, Principles, Sections 11.1, 11.6, 11.8, 10.2 and 10.4.

Principle 20 **Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme**

Proper valuation of collective investment scheme assets is critical to ensure investor confidence in CIS as a reliable and robust investment vehicle and for proper investor protection, especially in cases where a market price is unavailable. The regulatory framework should permit the responsible authority to ensure compliance with the relevant rules.

Key Issues

Asset Valuation

1. Regulation should ensure that all of the property of a CIS is fairly and accurately valued and that the net asset value (NAV) of the scheme is correctly calculated. The interests of the investor are generally better protected by the use of value based reporting²¹⁰ wherever reliable market or fair values can be determined.²¹¹
2. CIS should be valued regularly at specified intervals.
3. Information about asset value and pricing should allow the investor to assess performance over time.
4. Valuation methods should be applied consistently unless change is desirable in the interest of investors.

Pricing and Redemption Issues

5. Regulation should enable investors to redeem units upon a basis that is made clear in the constituent documents.
6. Incoming, continuing and outgoing investors should be treated equitably, such that purchases and redemptions of CIS interests are effected in a non-discriminatory manner.
7. Regulation should ensure that rights of suspension protect the interests of investors rather than the interests of the operator.
8. Regulators should be kept informed of any suspension of redemption rights.

²¹⁰ Value-based reporting is understood as marking financial assets to market or using market prices (values) where these are available and reliable.

²¹¹ Principles, Section 11.8 ¶ 1.

Key Questions

Asset Valuation

1. Are there specific regulatory requirements in respect of the valuation of CIS assets?²¹²
2. Are there regulatory requirements that the net asset value of assets be calculated:
 - a) On a regular basis?
 - b) In accordance with high-quality, accepted accounting standards used on a consistent basis?²¹³
3. Are there specific regulatory requirements in respect of the fair valuation of assets where market prices are not available?²¹⁴
4. Are independent auditors required to check the valuations of CIS assets?²¹⁵

Pricing and Redemption of Interests

5. Are there specific regulatory requirements in respect of the pricing upon redemption or subscription of interests in a CIS?²¹⁶
6. Does regulation ensure that the valuations made are fair and reliable?²¹⁷
7. Does regulation require the price of the CIS be disclosed or published on a regular basis to investors or prospective investors?²¹⁸
8. Are there regulatory requirements, rules of practice, and/or rules addressing pricing errors? Are the relevant regulatory authorities able to enforce these rules?²¹⁹
9. Does the regulatory framework address the general or specific circumstances in which there may be suspension or deferral of routine valuation and pricing or of regular redemption?²²⁰

²¹² Principles, Section 11.8. See also *Principles for the Supervision of Operators of Collective Investment Schemes*, supra. In addition, there should be some arrangement for valuing illiquid holdings if any. See also Key Issue 3.

²¹³ Id.

²¹⁴ Id.

²¹⁵ Principles, Section 11.4.

²¹⁶ Principles, Section 11.9.

²¹⁷ Principles, Section 11.8.

²¹⁸ Id.

²¹⁹ Id.

²²⁰ Principles, Section 11.9.

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10. Does the regulatory authority have the power to ensure compliance with the rules applicable to asset valuation and pricing? Is there evidence as to actions taken by the relevant regulatory authority in this area?²²¹
11. Does the regulatory framework require that the regulator:
 - a) Be kept informed of any suspension or deferral of redemption rights?
 - b) Have the power to take action, to demand, delay or stop the suspension or deferral of redemption rights?²²²

Benchmarks

Fully Implemented

Requires affirmative responses to all applicable Questions.

Broadly Implemented

Requires affirmative responses to all applicable Questions except to Questions 3, 8 and 11(b).

Partly Implemented

Requires affirmative responses to all applicable Questions except to Questions 3, 4, 8, 10 and 11(b).

Not Implemented

Inability to respond affirmatively to one or more of Questions 1, 2(a), 2(b), 5, 6, 7, 9 or 11(a).

Explanatory Notes

The calculation of the net asset value (NAV) of a CIS is extremely important, as the NAV²²³ reflects the price which an investor pays when investing in a CIS (subject to any additional up-front charges) and the price an investor will receive (subject to any additional exit charges) should a holding be liquidated. Assessors should pay proper attention to the calculation modalities and to the timing and the frequency of publication of NAV. Assessors also should evaluate whether the supervision of the CIS confirms that the operator has systems in place to ensure that calculations of the NAV are correct at each valuation point.

²²¹ Principles, Section 11.4.

²²² Principles, Section 11.4 and 11.9.

²²³ NAV is calculated by dividing the total value of the investments in a CIS by the number of units in issue, plus or minus adjustments for accrued fees, expenses and other liabilities.

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The type and frequency of valuation may depend on the availability and timing of redemption rights, the types of interests that may be held within a CIS, and the permitted legal structure of a CIS.

The right to redeem units is a key feature of open-ended funds. The assessor should evaluate whether the rules in place are sufficient to prevent fees or charges payable by an investor in the case of redemption from being conceived so as to prevent investors from exercising their rights. Assessors should take into account that rights of suspension not be exerted in ways that impair the protection of investors' interests and that regulators are able to enforce decisions aimed at protecting investors' interests. In the case of closed-end funds, assessors may consider how regularly such funds are priced.

G. Principles Relating to Market Intermediaries

1. Preamble

Regulation of the various types of intermediaries should address entry criteria, capital and prudential requirements, conduct of business, ongoing supervision and discipline of entrants, and the consequences of default and financial failure.²²⁴ In particular, regulation should aim to provide for:

- Proper ongoing supervision with respect to market intermediaries.
- The right to inspect the books, records and business operations of a market intermediary.²²⁵
- A full range of investigatory powers and enforcement remedies available to the regulator or other competent authority in cases of suspected or actual breaches of regulatory requirements.
- A fair and expeditious process leading to discipline and, if necessary, suspension or withdrawal²²⁶ of a license.
- The existence of an efficient and effective mechanism to address investor complaints.²²⁷

Principles 21 to 24 deal with market intermediaries. Principle 21 addresses authorization and the standards for authorization; Principle 22 addresses ongoing monitoring and the initial and ongoing capital requirements and prudential standards for intermediaries; Principle 23 addresses other operational standards for market intermediaries and standards for conduct of business to protect the interests of customers and for proper management of risks; and Principle 24 addresses procedures for minimizing the consequences to customers and markets of the failure of a market intermediary. These Principles should be assessed in conjunction with each other. In assessing the Principles, generally, it should be understood that there are two main approaches to the setting of capital adequacy standards for securities firms. A “net capital” approach is used in the United States, Canada, Japan and some other non-EU jurisdictions. The purpose of the net capital approach is, among other things, to protect customers and creditors by requiring broker-dealers to maintain sufficient liquid assets to allow the orderly self-liquidation of financially distressed broker-dealers. The other main approach is incorporated in the EU’s Capital Adequacy Directive, which is based on the amendment

²²⁴ Principles, Section 12.2 ¶ 2.

²²⁵ Inspection power should be available to a regulator to ensure compliance with all relevant requirements, even in the absence of a suspected breach of conduct. There must be complementary requirements for the maintenance of comprehensive records. See also Principle 8.

²²⁶ The term “withdrawal” would include revocation.

²²⁷ Principles, Section 12.7.

to the Basel Capital Accord to incorporate market risks.²²⁸ The emphasis in this approach is on ensuring the capital solvency of firms. The two approaches differ somewhat in their objectives, but their practical effects overlap to a significant extent. There may be other equivalent approaches that address the performance standards of the Principles.²²⁹

There are also different approaches to assessing the risks posed to securities firms by affiliated entities. One approach (used in the United States) is to require the regulated entity, the registered broker-dealer, to provide extensive “risk assessment” information to the regulator concerning its material affiliates. A number of other jurisdictions have regulatory authority over such affiliates and may require the affiliates to provide information to them directly. The EU generally requires securities firms to provide capital adequacy information on a consolidated basis and to meet capital requirements at the consolidated group level as well as at the level of individual regulated entities. The assessment criteria recognize that other approaches may be employed.

Assessors should assess each country’s capital adequacy standards by reference to that country’s approach, including calculation and what constitutes good capital.

Oversight of market intermediaries should be directed to the areas where capital, client money, and public confidence may most be put at risk including: ethical attitude; incompetence or poor risk management (which may lead to a failure of due execution, a failure to obtain due settlement or a failure to provide adequate advice); breach of duty (which may lead to misappropriation of client funds or property, the misuse of client instructions for the intermediary’s own trading purposes, i.e., “front running” or trading ahead of customers, manipulation and other trading irregularities, or fraud on the part of the intermediary or its employees); conflicts of interest and the insolvency of an intermediary (which may result in loss of client money, securities or trading opportunities, and may reduce confidence in the market in which the intermediary participates).²³⁰

2. *Scope*

“Market intermediaries” generally include those who are in the business of managing individual portfolios, executing orders and dealing in, or distributing, securities.²³¹

²²⁸ *Amendment to the capital accord to incorporate market risks*, Basel Committee on Banking Supervision (January 1996). See also Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions, *OJ L 141 11.06.1993 p.1*. See also Directive 98/31/EC of the European Parliament and of the Council of 22 June 1998 amending Council Directive 93/6/EEC on the capital adequacy of investment firms and credit institutions, *OJ L 204 21.07.1998 p.13*. See also Directive 98/33/EC of the European Parliament and of the Council of 22 June 1998 amending Article 12 of Council Directive 77/780/EEC on the taking up and pursuit of the business of credit institutions, Articles 2, 5, 6, 7, 8 of and Annexes II and III to Council Directive 89/647/EEC on a solvency ratio for credit institutions and Article 2 of and Annex II to Council Directive 93/6/EEC on the capital adequacy of investment firms and credit institutions, *OJ L 204 21.07.1998 p.29*.

²²⁹ Principle 21, Key Issues 6 and 7, *infra*, regarding investment advisers.

²³⁰ Principles, Section 12.2 ¶ 3.

²³¹ Principles, Section 12.2 ¶ 1. The distribution of securities generally includes solicitation.

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“Investment advisers” are those principally engaged in the business of advising others regarding the value of securities or the advisability of investing in, purchasing or selling securities.²³²

Three types of investment adviser are identified:

1. Investment advisers that deal on behalf of customers.
2. Investment advisers that do not deal on behalf of customers, but are permitted to have custody of client assets.
3. Investment advisers who neither deal on behalf of customers nor hold or have custody of customer assets nor manage portfolios, but who offer only advisory services without offering other investment services.²³³

The scope of these Principles applies differently to each type of adviser. Advisers that deal on behalf of customers should meet the capital and operational controls applicable to other market intermediaries.²³⁴ If advisers hold customer assets, they should meet requirements for protection of client assets. Those in the third category may not need to be licensed.²³⁵ In regulating the activities of investment advisers, the regulator may elect to put emphasis on the substantive licensing criteria and the capital and other requirements recommended for the regulation of market intermediaries. Alternatively, the regulator may opt for a disclosure-based regime designed to permit potential advisory clients to make an informed choice of advisers.²³⁶ The assessor should keep these distinctions in mind in applying the Principles in this section.

To the extent that this section calls for an assessment of the ongoing operations of intermediaries consistent with the Principles, the assessor should be certain that any conclusions reached are consistent with those contained in Principles 8, 9 and 10 related to enforcement and inspection powers and implementation of such powers.

²³² Principles, Section 12.8 ¶ 1.

²³³ Principles, Section 12.8 ¶ 2.

²³⁴ Id.

²³⁵ Where an investment adviser is offering advice through market intermediaries that are adequately licensed according to the Principles, separate licensing of the investment adviser may not be required. Principles, Section 12.8 ¶5. See also the footnotes to Principle 21.

²³⁶ Principles, Section 12.8 ¶ 3.

3. *Principles 21 through 24*

Principle 21 Regulation should provide for minimum entry standards for market intermediaries.

The supervision of market intermediaries should reduce the risk of loss to investors caused by incompetent, negligent or illegal behavior and/or inadequate capital. Minimum entry standards are an important means to regulate market intermediaries.²³⁷

Key Issues

*Authorization*²³⁸

1. The authorization, licensing²³⁹ or registration of market intermediaries should set minimum standards of entry that make clear the basis for authorization and standards that should be met on an ongoing basis. Such standards should include:
 - a) An initial minimum capital requirement as set forth in Principle 22.
 - b) A comprehensive assessment of the applicant and all those who are in a position directly or indirectly to control or materially influence the applicant. In this regard, regulation should determine whether participation in the market by an intermediary should be based upon a demonstration of appropriate knowledge, resources, skills and ethical attitude (including a consideration of past conduct).²⁴⁰
 - c) A requirement that the entry standards be consistently applied.²⁴¹

Authorization Authority

2. The licensing authority should have the power to:²⁴²
 - a) Refuse licensing of an intermediary, subject only to administrative or judicial review, if authorization requirements have not been met.

²³⁷ Principles, Section 12.3 ¶ 1.

²³⁸ Principles, Section 12.3.

²³⁹ In some jurisdictions authorization or registration is used instead of licensing. The term “license” should be understood to refer also to authorization and registration. See footnote 66 of the Principles.

²⁴⁰ Many jurisdictions set out detailed criteria relating to education, training, experience and the so-called “fitness and properness” of an applicant. These criteria are intended to protect the investor. Principles, Section 12.3 footnote 67.

²⁴¹ Principles, Section 12.3 ¶ 6. See also Principle 4.

²⁴² Principles, Section 12.3 ¶s 3 and 4.

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- b) Withdraw, suspend or condition a license or authorization where a change in control or other change results in a failure to meet relevant requirements.
3. Where licensing is the responsibility of a self-regulatory organization, the process should be subject to appropriate oversight by the regulator.²⁴³

Ongoing Requirements

4. Periodic updating of relevant information and reporting of material changes in circumstances affecting the conditions of licensing should be required. For example, changes in control or material influence should be required to be made known to the regulator to aim to ensure that its assessment of the intermediary remains valid.²⁴⁴
5. The regulator should aim to ensure that the public has access to relevant information concerning the licensee or authorized intermediary; such as, the identity of senior management and those authorized to act in the name of the intermediary; the category of license held; its current status and the scope of authorized activities.²⁴⁵

Investment Advisers

6. Investment advisers that deal on behalf of customers or that are permitted to have custody of client assets should be licensed.²⁴⁶
7. In regulating the activities of investment advisers, the regulator may elect to place emphasis on the substantive licensing criteria and the capital and other requirements recommended for regulation of other market intermediaries. Alternatively, the regulator may use a disclosure-based regime designed to permit potential advisory clients to make an informed choice of advisers subject to the activities performed by the investment adviser. The regulatory scheme should include the following requirements based on the type of adviser.²⁴⁷
 - a) If an investment adviser deals on behalf of customers, the capital and other operational controls applicable to other market intermediaries also should apply to the adviser.
 - b) If the adviser does not deal, but is permitted to have custody of client assets, regulation should provide for the protection of client assets, including segregation and periodic or risk-based inspections (either by the regulator or an independent third party).

²⁴³ Principles, Section 12.3 ¶ 6. See also Principle 7.

²⁴⁴ Principles, Section 12.3 ¶s 6 and 7.

²⁴⁵ Principles, Section 12.3 ¶ 8.

²⁴⁶ Principles, Section 12.3 ¶ 1.

²⁴⁷ Principles, Section 12.8 ¶s 2 and 3.

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8. At a minimum, however, the regulatory scheme selected for investment advisers should contain the following elements as applicable:²⁴⁸
 - a) A licensing regime that is sufficient to establish authorization to act as an investment adviser and to ensure access by the public to an up-to-date list of authorized advisers.
 - b) Bars against the licensing of persons who have violated securities or similar financial laws or criminal statutes during a specific time period preceding their application.
 - c) Record keeping requirements.
 - d) Clear and detailed requirements setting out the disclosures to be made by the adviser to potential clients, including: descriptions of the adviser's educational qualifications, relevant industry experience, disciplinary history (if any), investment strategies, fee structure and other client charges, potential conflicts of interest, and past investment performance (if relevant) that is updated periodically and as material changes occur.
 - e) Rules and procedures designed to prevent guarantees²⁴⁹ of future investment performance and misuse of client assets, and to prevent or address potential conflicts of interest.²⁵⁰
 - f) Inspection and enforcement powers.²⁵¹
9. There are investment advisers who neither deal on behalf of clients nor hold or have custody of client assets nor manage portfolios but who only offer advisory services without other investment services. In this case, separate licensing of the investment adviser may not be strictly required. It may be sufficient if the market intermediaries on whose services the advisers advise are adequately licensed according to the Principles.²⁵²

Key Questions

Authorization

1. Does the jurisdiction require that, as a condition of operating a securities business, the market intermediaries (as defined above) be licensed?²⁵³

²⁴⁸ Principles, Section 12.8 ¶ 4.

²⁴⁹ This does not refer to principal protected or guaranteed specified minimum rate of return plans for which appropriate disclosures are made.

²⁵⁰ Principle 21, Key Issue 8. It may not be possible to prevent or resolve all potential conflicts but conflicts should be avoided and if not resolvable, at least disclosed.

²⁵¹ Principles, Section 12.8 ¶ 4.

²⁵² Principles, Section 12.8 ¶s 3 and 5.

²⁵³ Principles, Section 12.3.

2. Are there minimum standards or criteria that all applicants for licensing must meet before a license is granted (or denied)²⁵⁴ and that are clear and publicly available which:
 - a) Are fair and equitable for similarly situated intermediaries?
 - b) Are consistently applied?
 - c) Include an initial capital requirement, as applicable?²⁵⁵
 - d) Include a comprehensive assessment of the applicant and all those in a position to control or materially influence the applicant that addresses “ethical attitude,” including past conduct, and appropriate proficiency requirements,²⁵⁶ such as, industry knowledge, skill and experience?
 - e) Include an assessment of the sufficiency of internal controls and risk management and supervisory systems in place, including relevant written policies and procedures?

Authority of Regulator

3. Does the relevant authority have the power to:²⁵⁷
 - a) Refuse licensing, subject only to administrative or judicial review, if authorization requirements have not been met?
 - b) Withdraw, suspend or condition a license where a change in control or other change results in a failure to meet relevant requirements on an ongoing basis?²⁵⁸
 - c) Take effective steps to prevent the employment of persons (or seek the removal of persons) who have committed securities violations or who are otherwise unsuitable from continuing to engage in intermediary activities, even if these persons are not separately licensed intermediaries if they can have a material influence on the firm?²⁵⁹

²⁵⁴ In some jurisdictions the criteria are stated for denying or disqualifying potential applicants.

²⁵⁵ Principle 22 and associated Explanatory Notes.

²⁵⁶ Such requirements would not be applied to shareholders for example.

²⁵⁷ Principles, Section 12.3.

²⁵⁸ Principle 4.

²⁵⁹ Compare Principle 8.

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4. Where licensing is the responsibility of a self-regulatory organization, is the process subject to appropriate oversight by the regulator?²⁶⁰

Ongoing Requirements

5. Are market intermediaries required to update periodically relevant information with respect to their license and to report immediately to the regulator (or licensing authority) material changes in the circumstances affecting the conditions of the license?²⁶¹
6. Is the following relevant information about licensed intermediaries available to the public?²⁶²
 - a) The existence of a license, its category and status?
 - b) The scope of permitted activities or identity of senior management and names of other individuals authorized to act in the name of the intermediary?
7. Does the regulator routinely monitor, investigate and enforce securities laws and regulations affecting intermediary activities?²⁶³

Investment Advisers

8. Does the regulatory scheme for investment advisers require that?²⁶⁴
 - a) If an investment adviser deals on behalf of customers, the capital and other operational controls applicable to other market intermediaries also should apply to the adviser?
 - b) If the adviser does not deal, but is permitted to have custody of client assets, regulation provides for the protection of client assets, including segregation and periodic or risk-based inspections (either by the regulator or an independent third party)?
 - c) In the case of both (a) and (b), as well as advisers who manage client portfolios without dealing on behalf of clients or holding client assets, does regulation include:
 - i) Record-keeping requirements?

²⁶⁰ Principles, Section 12.3. See also Principle 7.

²⁶¹ Id. There should be regular information provided to the regulator that indicates the market intermediary's ongoing activities. In addition, where there is a change in the market intermediary's staff, activities or environment that would have a material effect on its ability to perform its role, this should be reported to the regulator in a timely fashion.

²⁶² Principles, Section 12.3.

²⁶³ Principles, Section 12.7. See also Principles 8, 9 and 10.

²⁶⁴ Principles, Section 12.8.

- ii) Clear and detailed requirements setting out the disclosures to be made by the adviser to potential clients, including: descriptions of the adviser's educational qualifications, relevant industry experience, disciplinary history (if any), investment strategies, fee structure and other client charges, potential conflicts of interest, and past investment performance (if relevant)?
- iii) Rules and procedures designed to prevent guarantees of future investment performance, misuse of client assets, and potential conflicts of interest?²⁶⁵

Benchmarks²⁶⁶

Fully Implemented

Requires affirmative responses to all applicable Questions.

Broadly Implemented

Requires affirmative responses to all applicable Questions except to Question 6(b).

Partly Implemented

Requires affirmative responses to all applicable Questions except to Questions 2(b), 2(e), 3(c), 6(b), 7 and 8(c)(iii) and the absence of circumstances where the criteria for licensing and refusal of licenses are subjective and capable of being applied differently to similarly situated intermediaries.

Not Implemented

Inability to respond affirmatively to one or more of Questions 1, 2(a), 2(c), 2(d), 3(a), 3(b), 4, 5, 6(a), 8(a), 8(b), 8(c)(i) or 8(c)(ii), to the extent applicable.

Explanatory Notes

Some jurisdictions may license²⁶⁷ persons who operate a CIS as CIS operators; other jurisdictions may license CIS operators as investment advisers. This characterization,

²⁶⁵ Principle 21, Key Issue 8.

²⁶⁶ In the case of investment advisers, affirmative answers are only required to those Questions applicable to the category of adviser(s) permitted in the jurisdiction. This does not refer to principal protected or guaranteed specified minimum rate of return plans for which appropriate disclosures are made.

²⁶⁷ In some jurisdictions authorization or registration is used instead of licensing. The term "license" should be understood to refer also to authorization and registration. See footnote 66 of the Principles.

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however, should be without prejudice to the assessment under Principles 17 through 20 that should be performed according to the assessment criteria for those Principles.

Recognition of another licensing regime in connection with access to domestic customers by a foreign intermediary subject to relevant conditions is contemplated as being a licensing or authorization program under the assessment benchmarks, provided that the criteria used are transparent, clear, consistently applied and address the objectives of the Principles. Where individuals or entities are licensed, registered or authorized in more than one capacity, assessors must assure what criteria are applied to each category.

Principle 22 **There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.**

Establishment of an adequate initial and ongoing capital standard increases the protection of investors and the integrity of financial systems. A firm should be required to ensure that it maintains adequate financial resources to meet its business commitments and to withstand the risks to which its business is subject. Risk may result from the activities of unlicensed and off-balance sheet affiliates; regulation should consider the need for information about the activities of these affiliates.²⁶⁸

Capital adequacy standards foster confidence in the financial markets and investor protection.

Key Issues

1. There should be an initial capital requirement for relevant market intermediaries as a condition of authorization. This requirement should be based on a capital adequacy test that addresses the risks to such firms judged by reference to the nature and amount of the business *expected to be* undertaken.²⁶⁹
2. There should be an ongoing capital requirement directly related to the nature of the risks and the amount of business *actually* undertaken by a market intermediary. The capital requirement should be maintained by the intermediary and subject to timely periodic reporting to the regulator or competent SRO. This should involve a combination of regular reporting and one-off trigger-based, early warning reporting when the threshold levels for minimum capital are approached.²⁷⁰
3. Capital adequacy standards should be designed to allow a market intermediary to absorb some losses and continue to operate, particularly in the event of large, adverse market moves, and to achieve an environment in which it could wind down its business over a relatively short period without loss to its customers or the customers of other firms and without disrupting the orderly functioning of the financial markets.²⁷¹
4. An intermediary should be subject to:
 - a) Independent audits of its financial condition.

²⁶⁸ Principles, Section 12.3 ¶ 6. See also Principles, Section 12.4 footnotes 70, 71, 74.

²⁶⁹ Principles, Section 12.4 ¶ 4.

²⁷⁰ Principles, Section 12.3. See also Principles, Section 12.4 ¶ 2.

²⁷¹ Principles, Section 12.4 ¶ 2.

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- b) Periodic and for cause examinations by a regulator or an SRO that is subject to regulatory oversight.²⁷²
5. The regulator should have specific authority to impose restrictions on an intermediary's regulated business activities and more stringent capital monitoring and/or reporting requirements if an intermediary's capital deteriorates or when it falls below minimum requirements.²⁷³
6. Any exposure of a market intermediary to significant risks arising from the activities of other entities in its group(s) should be addressed. Consideration should be given as to the need for information about the activities of unlicensed and off balance sheet affiliates.²⁷⁴

Key Questions

1. Are there initial and ongoing minimum capital requirements for relevant market intermediaries?²⁷⁵
2. Are the capital adequacy requirements structured to result in capital addressed to the full range of risks to which market intermediaries are subject, e.g., market, credit, liquidity, operational, and legal, including reputational, risks?²⁷⁶
3. Are capital adequacy requirements sensitive to the quantum of risks undertaken; that is, does required capital increase as risk increases, e.g., in the event of large market moves?²⁷⁷
4. Are capital standards sufficient to allow an intermediary to absorb some losses and to wind down its business over a relatively short period without loss to its customers or disrupting the orderly functioning of the markets?²⁷⁸

²⁷² Principles, Section 12.5 ¶ 2.

²⁷³ For example, when it is determined that an intermediary is in danger of not being able to fulfill its obligations towards its customers, the market or its creditors, or it is determined that the intermediary's financial condition is deteriorating although still above minimum requirements. Assessors should note that although this is a regulatory requirement, in the first instance, the responsibility for managing risks rests with the firm. See also Principle 23 and Principles, Section 12.6 ¶ 3.

²⁷⁴ IOSCO Public Document No. 14, *Capital requirements for multinational securities firms*, IOSCO Technical Committee (November 1990). See also IOSCO Public Document 116. *Multi-Disciplinary Working Groups on Enhanced Disclosure: Joint report of the Basel Committee on Banking Supervision, the Committee on the Global Financial System of the G-10 Central Banks, the International Association of Insurance Supervisors and IOSCO* (April 2001). See also IOSCO Public Document No. 122 *Risk management practices and regulatory capital: A cross-sectoral comparison*, Joint Forum on Financial Conglomerates (November 2001).

²⁷⁵ Principles, Section 12.4.

²⁷⁶ Principles, Section 12.4, footnote 65. An example of reputational risk is marketplace concern about an intermediary's solvency that may affect its ability to access credit facilities and/or to clear and settle transactions with counterparties.

²⁷⁷ Principles, Section 12.4.

²⁷⁸ Principles, Section 12.3.

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5. Are relevant market intermediaries required to maintain records such that capital levels can be readily determined at any time?²⁷⁹
6. Are the detail, format, frequency and timeliness of reporting to the regulator and/or the SRO sufficient to reveal a significant deterioration in the capital adequacy position of market intermediaries?²⁸⁰
7. Is the financial position of the intermediary subject to audit by independent auditors to provide additional assurance that the financial position reflects the risk that the intermediary undertakes?²⁸¹
8. Does the regulator:²⁸²
 - a) Regularly review market intermediaries' capital levels?
 - b) Take appropriate action when these reviews indicate material deficiencies?
9. Does the regulator have specific authority to impose restrictions on an intermediary's regulated business activities and more stringent capital monitoring and/or reporting requirements if an intermediary's capital deteriorates so as to endanger its capacity to fulfill its obligations or when it falls below minimum requirements? Is there evidence that the regulator exercises this authority?²⁸³
10. Does the capital framework address risks from outside the regulated entity, for example from unlicensed affiliates or from off-balance sheet risks?²⁸⁴

Benchmarks

Fully Implemented

Requires affirmative responses to all applicable Questions.

Broadly Implemented

Requires affirmative responses to all applicable Questions except to Question 10.

Partly Implemented

Requires affirmative responses to all applicable Questions except to Questions 6, 9 and 10.

²⁷⁹ Principles, Section 12.3.

²⁸⁰ Id.

²⁸¹ Id.

²⁸² Id. See also Principles, Section 12.6.

²⁸³ Principles, Section 12.6.

²⁸⁴ Principles, Section 12.4.

Not Implemented

Inability to respond affirmatively to one or more of Questions 1, 2, 3, 4, 5, 7, 8(a) or 8(b).

Explanatory Notes:

Some market intermediaries act in such a way that their activity is of lower risk. Where the market intermediary merely introduces accounts, is an inter-dealer broker with no principal at risk, or operates on a matched book (counterparty basis), it may be appropriate to set capital requirements at a level lower than the level applicable to intermediaries that carry customer assets or take principal positions for their own account.²⁸⁵

Capital adequacy requirements may explicitly refer to a particular risk, but be set at a level that in practice covers other risks as well. The assessor should inquire about the method of minimum capital determination being used and the types of intermediaries in the jurisdiction to which it applies, taking into account that more than one method or technique of computing capital or capital requirements is permitted under the Principles.²⁸⁶ For an overview of alternative approaches to capital adequacy, see the preamble to this section on Intermediaries.

²⁸⁵ Principles, Section 12.4 ¶ 3.

²⁸⁶ For greater detail on the specified risks, IOSCO Public Document No. 77, *Methodologies for Determining Minimum Capital Standards for Internationally Active Securities Firms Which Permit the Use of Models Under Prescribed Conditions*, IOSCO Technical Committee (May 1998).

Principle 23 Market intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters.

Market intermediaries should conduct their businesses in a way that protects the interests of their clients and helps preserve the integrity of the market. Regulation should require that market intermediaries have in place appropriate internal policies and procedures for observance of securities laws and appropriate internal controls and risk management systems. It is not practicable for the regulator to oversee adherence to those internal procedures on a day-to-day basis. Senior management of the market intermediary must bear primary responsibility for adherence to internal procedures and must understand the firm's business, its internal control procedures and environment, and its policies on the assumption of risk.²⁸⁷

Instances of operational breach can occur despite the existence of internal procedures designed to prevent misconduct or negligence. Regulation should not be expected to remove risk from the market place but should aim to ensure that there is proper management of that risk.²⁸⁸

Key Issues

Management and Supervision

1. The management of a market intermediary should bear primary responsibility for ensuring the maintenance of appropriate standards of conduct and adherence to proper procedures by the whole firm.²⁸⁹ This includes ensuring that the firm is structured appropriately and has an adequate internal structure and controls, given the types of business in which it engages to ensure investor protection and the management of risks.
 - a) Senior management must ensure adherence to internal procedures on a day-to-day basis. They must understand the nature of the firm's business, its internal control procedures and policies on the assumption of risk, and clearly understand the extent of their own authority and responsibilities.²⁹⁰

²⁸⁷ Principles, Section 12.5 ¶s 1 and 2.

²⁸⁸ Principles, Section 12.5 ¶ 3.

²⁸⁹ Principles, Section 12.5 ¶ 2.

²⁹⁰ Id.

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- b) Information must be timely and readily accessible to senior management and such information should be subject to procedures intended to maintain its security, availability, reliability and integrity.²⁹¹
2. Periodic evaluation of risk management processes within a regulated entity is appropriate. This should be conducted by someone of sufficient autonomy so as not to compromise the evaluation. SROs and third parties, such as external auditors, may be used to assist in this process.²⁹²

Protection of Customers

3. The intermediary should have an efficient and effective mechanism for the resolution of investor complaints.²⁹³
4. Market intermediaries should conduct themselves in a way that protects the interest of their clients and helps to preserve the integrity of the market. Fundamental principles include:²⁹⁴
 - a) A firm should observe high standards of integrity and fair dealing.
 - b) A firm should act with due care and diligence in the best interests of its customers and the integrity of the market.
 - c) A firm should observe high standards of market conduct.²⁹⁵
 - d) A firm should not place its interests above those of its customers and should give similarly situated treatment to similarly situated customers.
 - e) A firm should comply with any law, code or standard relevant to securities regulation as it applies to the firm.
5. With regards to an intermediary's conduct with customers, the following are to be considered as important components:²⁹⁶
 - a) The customer should be able to obtain a written contract of engagement or account agreement or a written form of the general and specific conditions of doing business through the intermediary.²⁹⁷

²⁹¹ Id.

²⁹² Principles, Section 12.5 bullet point 6 on Market Practices.

²⁹³ Principles, Section 12.7 ¶ 2, see also Principle 8 and the related Explanatory Note.

²⁹⁴ Principles, Section 12.5 ¶s 6 and 8.

²⁹⁵ Principles, Section 12.7.

²⁹⁶ Principles, Section 12.5 ¶ 4 and associated bullet points. See also discussion under Principle 21 regarding how these standards should apply to certain types of investment advisers.

²⁹⁷ The "writings" necessary to evidence the contract may be governed by the contract law of the jurisdiction and may include electronic transmissions.

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- b) A firm should seek from its customers any information about their circumstances and investment objectives relevant to the services to be provided.
 - c) Where the activities of an intermediary extend to giving specific advice, the advice should be given upon an understanding of the needs and circumstances of the customer, a matter generally encompassed in the rule of conduct that the intermediary must “know your client.”²⁹⁸
 - d) The firm should make adequate disclosure to its customers in a comprehensible and timely way so that the customer can make an informed investment decision. It may be necessary for regulation to require a particular form of disclosure where products carry risk that may not be readily apparent to the retail customer.²⁹⁹
 - e) A firm should promptly, and at suitable intervals, provide each customer with a full and fair report of the value and composition of the customers’ account or portfolio including, as appropriate, an account of transactions and balances and any associated fees and commissions.³⁰⁰
6. Where an intermediary has control of, or is otherwise responsible for, assets belonging to a customer which it is required to safeguard, it should arrange proper protection for them (for example, segregation and identification of those assets) in accordance with its responsibility.³⁰¹

Internal Controls

7. The details of the appropriate internal organization of a firm will vary according to the size of the firm, the nature of its business and the risks it undertakes. With regards to an intermediary’s internal organization, the regulatory framework should require the following to be considered:³⁰²
- a) Compliance with all applicable legal and regulatory requirements, as well as, with the firm’s own internal policies and procedures should be monitored by a separate compliance function that reports directly to senior management in a structure that makes it independent from operational divisions.
 - b) Maintenance of effective policies and operational procedures and controls in relation to the firm’s day-to-day business, including clear policies covering the circumstances in which proprietary trading is permitted, and

²⁹⁸ In this context, the “know your customer” principle relates to suitability of investment recommendations and disclosure obligations. It should be distinguished from obligations relating to client identification imposed to prevent money laundering.

²⁹⁹ Principles, Section 12.5 bullet point 4 on Information About Customers.

³⁰⁰ Principles, Section 12.5 ¶ 4, bullet points on Terms of Engagement and Information for Customers.

³⁰¹ Principles, Section 12.5 bullet point 5 on Customer Assets.

³⁰² Principles, Section 12.5 ¶ 4.

procedures to ensure the integrity, security, availability, reliability and thoroughness of all information.³⁰³

- c) Evaluation of the “effectiveness” of those operational procedures and controls in the light of whether they serve reasonably to ensure:
 - i) An effective exchange of information between the firm and its clients, including required disclosures of information to clients.
 - ii) The integrity of the firm’s dealing practices, including the treatment of all clients in a fair, honest and professional manner.
 - iii) The safeguarding of both the firm’s and its clients’ assets against unauthorized use or disposition.
 - iv) The maintenance of proper accounting and other applicable records, and the reliability of the information.
 - v) Compliance with all relevant legal and regulatory requirements.
 - vi) Appropriate segregation of key duties and functions, particularly those duties and functions which, when performed by the same individual, may result in undetected errors or may be susceptible to abuses which expose the firm or its clients to inappropriate risks.³⁰⁴
- d) Avoidance of any conflict of interest arising between its interests and those of its customers. Where the potential for conflicts arise, a firm should ensure fair treatment of all its customers by proper disclosure, internal rules of confidentiality or declining to act where conflict cannot be avoided.³⁰⁵

Key Questions

Management and Supervision

1. Is an intermediary required to have:
 - a) An appropriate management and organization structure?
 - b) Adequate³⁰⁶ internal controls?

³⁰³ Principles, Section 12.5 bullet point 7 on Operational Controls and Proprietary Trading.

³⁰⁴ Principles, Section 12.5 bullet point 8 on Operational Controls, subsections (a) through (f).

³⁰⁵ Principles, Section 12.5 bullet point 9 on Conflicts of Interest.

³⁰⁶ The notion of adequacy should take into account the size of the firm, the nature of its business and the types and amount of risks it undertakes.

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- c) Senior management that is required to bear primary responsibility for ensuring the maintenance of appropriate standards of conduct and adherence to proper procedures by the whole firm?³⁰⁷
2. Is an intermediary required to cause an independent,³⁰⁸ periodic evaluation of its internal controls and risk management processes to be performed? Where the firm elects an evaluation performed by an independent auditor, is that auditor required to report material breakdowns in controls to senior management and to the regulator?³⁰⁹

Customer Protection

3. Is the intermediary required to provide for an efficient and effective mechanism for the resolution of investor complaints?³¹⁰
4. If an intermediary has control of, or is otherwise responsible for, assets belonging to a customer which it is required to safeguard, are there regulations that require proper protection for them (for example, segregation and identification of those assets) by the intermediary? Do these measures facilitate the transfer of positions; assist in the orderly winding up in the event of financial insolvency and otherwise provide protection from misuse by the intermediary?³¹¹
5. Is an intermediary required to obtain and retain basic information from a customer about concerns and issues involving investment objectives relevant to the service to be provided?³¹²
6. Is an intermediary required to “know its customer” before providing specific advice to a customer?³¹³
7. Can a customer obtain an agreement or contract or a written form of the general and specific business conditions that sets forth the terms on which the customer will be dealing?³¹⁴
8. Is an intermediary required to provide general or specific disclosures to customers of information needed to make a balanced and informed investment decision?³¹⁵

³⁰⁷ Principles, Section 12.5 ¶ 2.

³⁰⁸ This evaluation should be performed by someone of sufficient autonomy so as not to compromise the evaluation.

³⁰⁹ Principles, Section 12.5 ¶ 2.

³¹⁰ Principles, Section 12.7.

³¹¹ Principles, Section 12.5 ¶ 4 bullet point on Customer Assets.

³¹² Principles, Section 12.5 ¶ 4 bullet point on Information about Customers.

³¹³ Id.

³¹⁴ Principles, Section 12.5 ¶ 4 bullet point on Terms of Engagement.

³¹⁵ Principles, Section 12.5 ¶ 4 bullet point on Information for Customers.

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9. Is an intermediary required to provide a customer with a full and fair statement of account (and information regarding remuneration received by the intermediary for services provided to the customer)?³¹⁶

Internal Controls

10. Is the intermediary required to have a person or group of persons responsible for monitoring its compliance with legal and regulatory requirements as well as with its internal policies and procedures?³¹⁷
11. Is an intermediary required to create and maintain adequate and reliable books and records, including accounting records? Is the intermediary required to maintain those books and records in a way that allows full supervision by the regulator?³¹⁸
12. Is an intermediary required to establish and maintain appropriate systems of customer protection, risk management and internal and operational controls, including policies, procedures, and controls relating to all aspects of its business intended reasonably to ensure:³¹⁹
- a) An effective exchange of information between the firm and its clients, including required disclosures of information to clients?
 - b) The integrity of the firm's dealing practices, including the treatment of all clients in a fair, honest and professional manner?
 - c) The safeguarding of both the firm's and its clients' assets against unauthorized use or disposition?
 - d) The maintenance of proper accounting and other applicable records and the reliability of the information?
 - e) Compliance with all relevant legal and regulatory requirements?
 - f) Appropriate segregation of key duties and functions, particularly those duties and functions which, when performed by the same individual, may result in undetected errors or may be susceptible to abuses which expose the firm or its clients to inappropriate risks?

³¹⁶ Principles, Section 12.5 ¶ 4 bullet point on Terms of Engagement.

³¹⁷ Principles, Section 12.5 ¶ 4 bullet point on Market Practice.

³¹⁸ Principles, Section 12.5 ¶ 4 bullet point on Operational Controls.

³¹⁹ Id. Reference should be made to Principle 23, Key Issue 7. The structure of a firm's control systems can be expected to vary based on the size of the firm and the nature of its business. These controls address prudential issues, risk management and conduct of business rules or treatment of customers, in particular that the firm act with due care and diligence in the best interests of its customers and the markets, and observe high standards of fair dealing.

13. Is an intermediary required:³²⁰
- a) To endeavor to avoid a conflict of interests arising between its interests and those of its customers or between its customers?
 - b) Where the potential for conflicts arise, to have mechanisms in place to ensure fair treatment of all its customers such as proper disclosure, internal rules of confidentiality, declining to act where conflict cannot be avoided?

Benchmarks

Fully Implemented

Requires affirmative responses to all applicable Questions.

Broadly Implemented

Requires affirmative responses to all applicable Questions except to Question 3.

Partly Implemented

Requires affirmative responses to all applicable Questions except to Questions 2, 3, 6, 7, 12(a), 12(b), 12(c), 12(d), 12(f) and either 13(a) or 13(b).

Not-Implemented

Inability to respond affirmatively to one or more of Questions 1(a), 1(b), 1(c), 4, 5, 8, 9, 10, 11, 12(e) or to both 13(a) and 13(b).

Explanatory Notes:

Treatment of customer funds also may be relevant to adequacy of capital as addressed in Principle 22.

What constitutes adequate disclosure by an intermediary may depend on the type of services being offered. For example, the disclosures required of a pure order taker would be different from those of a full service broker also providing investment advice.

The measures that could be taken in response to Key Question 4 are intended to: provide protection from defalcation; facilitate the transfer of positions in the event of firm failure or market disruption; prevent the use of client funds for proprietary trading or the financing of an intermediary's operations; and assist in the orderly winding up upon the insolvency of an individual firm. In evaluating Key Questions 5, 6 and 8 through 13, the assessor should consider whether there is evidence that the regulator has programs to aim to ensure that the intermediary observes these requirements in practice.

³²⁰ Principles, Section 12.5 ¶ 4 bullet point on Conflicts of Interest.

Principle 24 There should be a procedure for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.

The failure of a market intermediary can have a negative impact on customers and counterparties and may have systemic consequences. The regulator must have a clear and flexible plan in place to deal with the eventuality of failure by market intermediaries. The regulator should attempt to minimize damage and loss to the investor. This may involve restraining conduct of the market intermediary and/or its principals, directing the management of assets and providing information to the market as necessary. Where applicable, the regulator should have appropriate arrangements in place with other relevant regulators.

Key Issues³²¹

1. The regulator should have a clear plan for dealing with the eventuality of failure by market intermediaries. The circumstances of financial failure are unpredictable so the plan should be flexible.³²²
2. The regulator should attempt to minimize damage and loss to the investor caused by the failure of an intermediary. A combination of actions to restrain conduct, to aim to ensure that assets are properly managed, and to provide information to the market may be necessary.³²³
3. Depending upon the prevailing domestic bank regulatory model, it may also be necessary to cooperate with banking regulators, and if the domestic arrangements require it, insolvency authorities. As a minimum position, the regulator should have identified contact persons³²⁴ at other relevant domestic and foreign regulators.³²⁵

Key Questions

1. Does the regulator have clear plans for dealing with the eventuality of a firm's failure, including a combination of activities to restrain conduct, to ensure assets are properly managed and to provide information to the market as necessary?³²⁶

³²¹ Principles, Section 12.6

³²² Principles, Section 12.6 ¶ 1.

³²³ Principles, Section 12.6 ¶ 2.

³²⁴ See Explanatory Note to Principle 12.

³²⁵ Principles, Section 12.6 ¶ 3.

³²⁶ Principles, Section 12.6 ¶ 1.

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2. Are there early warning systems or other mechanisms in place to give the regulator notice of a potential default by a market intermediary and time to address the problem and to take corrective actions?³²⁷
3. Does the regulator have the power to take appropriate actions: In particular, can it:³²⁸
 - a) Restrict activities by the intermediary with a view to minimizing damage and loss to investors?
 - b) Require the intermediary to take specific actions, for example, moving client accounts to another intermediary?
 - c) Request appointment of a monitor, receiver, curator or other administrator or, in the absence of such power, can the regulator apply to the relevant authorities to take possession or control of the assets held by the intermediary or by a third party on behalf of the intermediary?
 - d) Require that relevant information concerning a firm's failure (i.e. a firm's trading status) be disclosed to the market?
 - e) Apply other available measures intended to minimize customer, counterparty and systemic risk in the event of intermediary failure, such as customer and settlement insurance schemes or guarantee funds?
4. Do the regulator's processes and procedures for addressing financial disruption include communication and cooperation with other regulators, both domestic and foreign, where appropriate, and is there evidence that contact arrangements are in place and that such cooperation occurs?³²⁹

Benchmarks

Fully Implemented

Requires affirmative responses to all applicable Questions.

Broadly Implemented

Requires affirmative responses to all applicable Questions except to Questions 3(d) and 3(e).

Partly Implemented

Requires affirmative responses to all applicable Questions except to Questions 3(b), 3(c), 3(d) and 3(e).

³²⁷ Principles, Section 12.4 ¶ 2. See also Principles, Section 12.6 ¶ 1.

³²⁸ Principles, Section 12.6 ¶ 2.

³²⁹ Principles, Section 12.6 ¶ 3.

Not Implemented

Inability to respond affirmatively to one or more of Questions 1, 2, 3(a) or 4.

Explanatory Note:

In assessing the adequacy of the regulatory regime to protect customer assets in the possession of failed or failing intermediaries, in addition to consideration of the adequacy of capital and other prudential regulations, including segregation if applicable, it is appropriate to consider the availability and adequacy of insurance and/or compensation schemes designed to protect customers' funds and securities in the event of an intermediaries' insolvency, as well as settlement assurance schemes or other arrangements that may minimize counterparty and systemic risk.

The assessor should indicate what combination of arrangements is available and how they are intended to mitigate risk.

Assessments of Principle 24 should be consistent with any findings related to risk management practices under Principles 29 and 30.

H. Principles Relating to the Secondary Markets

1. Preamble

Regulators in all jurisdictions acknowledge that investors want fair, efficient and transparent secondary markets. The Principles under this section are intended to promote these objectives.³³⁰ The fairness of the markets is closely linked to investor protection and to the prevention of improper trading practices.³³¹

Principles 25 through 29 examine how a jurisdiction's overall regulatory structure ensures the integrity of regulated markets.

Principles 25 and 26 examine the general requirements for authorization of exchanges and trading systems and their on-going supervision. Specifically, Principle 25 examines the criteria that are required when an exchange or trading system is *initially* authorized in a jurisdiction. Principle 26, on the other hand, examines the procedures by which the regulator is assured of the *on-going compliance* by an authorized exchange or regulated trading system with the relevant conditions thought necessary as pre-requisites to authorization.

Principles 27, 28 and 29 focus on specific regulatory objectives that are intended to promote market integrity. Principle 27 focuses on the extent to which the regulatory structure promotes transparency (defined in terms of the availability of pre-trade and post-trade information). Principle 28 focuses on the regulations and mechanisms that prohibit, detect and deter manipulative, fraudulent, and deceptive conduct or other market abuses. Finally, Principle 29 focuses on the mechanisms in place to ensure the proper management of large exposures, defaults and market disruptions.

2. Scope

Prerequisites to Assessment – Market Structure and Authority

Authorized exchanges and regulated trading systems, that is, market systems that bring together multiple buyers and sellers in a manner that results in completed transactions or trades, are the main focus of this assessment.³³² The operation of some exchanges and trading systems is performed by the markets and systems themselves. In others, it is undertaken by a separate entity that acts as the operator. In this section, the terms “authorized exchange” and “regulated trading system” should be understood to include both of these types of exchanges and trading systems.³³³

³³⁰ IOSCO Public Document No. 90, *Supervisory Framework for Markets*, IOSCO Technical Committee (May 1999).

³³¹ Principles, Section 4.2.2 ¶ 2.

³³² Principles, Section 13.2.

³³³ References to “operator” herein should be understood to include the authorized exchange or regulated trading system and vice versa.

Nonetheless, in this section on Secondary Markets, the term “markets” should be understood in its widest sense, including facilities and services relevant to equity and debt securities, and to options and other derivative products. The appropriate level of regulation will depend upon the characteristics of the market in question, including: the structure of the market and the sophistication of its participants; rights of access; types of products traded; the degree of integration with other markets; the extent of cross-border business; the impact of technological developments; and the ability of the operators to fulfill any self-regulatory and risk management role under the powers and authority granted by law.

Because regulation may differ according to market structure, market participant or product, information about such differences and the rationale for such differences is an important component of any assessment. For example, the Principles do not specify particular regulatory methodologies. In most cases the Principles may be implemented by legislation, administrative rules, advisories, guidelines or procedures, market rules, equitable principles of trade or best practices, or professional market codes of conduct, agreed market conventions or, for electronic markets, integrated into the algorithm; provided, however, that whatever method of implementation is chosen is enforceable to the extent necessary to achieve its objectives and takes into account the Benchmarks.

Accordingly, in order to accurately assess regulatory structure, assessors must understand the market structure, including clearing and settlement arrangements, types of participants and international linkages (both foreign and domestic). The Introduction to this Assessment Methodology provides further guidance regarding the effect of market structure on the approach to undertaking an assessment.

The Principles also recognize that “in some cases it will be appropriate that a trading system should be largely exempt from direct regulation...” but will require approval from the relevant regulator after proper consideration by the regulator of the type of approval (or exemption) necessary.³³⁴ If this is the case, the criteria should be transparent, accessible and consistently applied.³³⁵

For example, in many jurisdictions, the authorization or recognition process and relevant requirements for electronic trading systems sponsored by foreign operators may differ from the process for fully domestic systems.³³⁶ Similarly, some jurisdictions may provide tiered levels of regulation for markets depending upon the type of product traded and

³³⁴ Principles, Section 13.3. See also IOSCO Public Document No. 90, *Supervisory Framework for Markets*, IOSCO Technical Committee (May 1999).

³³⁵ For example, exemption from some requirements for trading systems with limited trading volumes may be appropriate. Also, in many jurisdictions, the trading markets for sovereign (and in some cases, sub-sovereign) debt securities are not subject to regulation, or subject to more limited regulation, than the trading markets for corporate securities.

³³⁶ Principles, Section 5, on the Regulatory Environment. There should, however, be no unnecessary barriers to entry and exit from markets and products. In some cases, these may be caused by laws not subject to the control of regulators, such as fiscal or other general laws. See Annex 1 in Book II or Principles, Annexure 3. For example, however, access criteria can be based on mutual recognition, additional disclosure or other requirements.

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sophistication of the participants. Still other jurisdictions regulate alternative trading systems as brokers and apply regulation consistent with that for market intermediaries under these Principles coupled with certain rules on transparency, insider trading and market abuse prohibitions. Such flexibility in regulation is consistent with the Principles. Differences related to the type of service provided, product traded and participants in the market are generally accepted bases for drawing appropriate regulatory distinctions.³³⁷

Confidence in the rule of law, the enforceability of contracts and the adequacy of commercial and insolvency law are critical to the effective regulation of secondary markets, so to the extent gaps exist these should be identified in the assessment.³³⁸ Assessors should also take into account the adequacy of related clearing and settlement arrangements either as the result of separate assessment under the CPSS/IOSCO Recommendations for Clearing and Settlement Systems or by reference to Principle 30 in the case of derivatives markets.

³³⁷ *Supervisory Framework for Markets*, supra, Section IV. A., Alternative Trading Systems.

³³⁸ Annex 1.

3. *Principles 25 through 29*

Principle 25 **The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight.**

The regulator's authorization of exchanges and trading systems and of trading rules helps to ensure fair and orderly markets.³³⁹ The fairness of markets is closely linked to investor protection and, in particular, by the prevention of improper trading practices, to confidence in the markets. Market structures should not unduly favor some market users over others.

Regulation should aim to ensure that investors are given fair access to market facilities and market or price information. Regulation should promote market practices and structures that ensure fair treatment of orders and a price formation process that is reliable.³⁴⁰

Key Issues³⁴¹

Criteria for authorization

Exchanges or Trading Systems Subject to Regulation

1. Regulation should assess the initial and ongoing propriety and competence of the operator of an exchange or trading system as a secondary market. The operator should be accountable to the regulator and, when assuming principal, settlement, guarantee or performance risk, should comply with prudential and other requirements designed to reduce the risk of non-completion of transactions.

Supervision

2. The regulator should assess the reliability of all the arrangements made by the operator for the monitoring, surveillance and supervision of the exchange or trading system and its members or participants to ensure fairness, efficiency, transparency and investor protection, as well as compliance with securities

³³⁹ Assessors should refer to the following IOSCO reports for background: IOSCO Public Document No. 42, *Report on Issues in the Regulation of Cross-Border Proprietary Screen-Based Trading Systems*, IOSCO Technical Committee (October 1994). See also IOSCO Public Document No. 6, *Screen-Based Trading Systems for Derivative Products*, IOSCO Technical Committee (June 1990). See also IOSCO Public Document No. 111, *Principles for the Oversight of Screen-Based Trading Systems for Derivatives Products - Reviews and Additions*, IOSCO Technical Committee (October 2000). See also IOSCO Public Document No. 83, *Securities Activity on the Internet*, IOSCO Technical Committee (September 1998) and IOSCO Public Document No. 120, *Securities Activity on the Internet II*, IOSCO Technical Committee (June 2001).

³⁴⁰ Principles, Section 4.2 ¶ 2.

³⁴¹ Unless otherwise noted, all Key Issues for this Principle are derived from the prescriptive statements in Principles, Section 13.3.

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legislation. There must be mechanisms in place to identify and address disorderly trading conditions and to ensure that contravening conduct, when detected, will be dealt with.

Products and Participants

3. The regulator should, as a minimum requirement, be informed of the types of securities and products to be traded on the exchange or trading system, and should review/approve the rules governing the trading of the product, where applicable. In doing so, the market and/or the regulator should:
 - a) Consider product design principles, where applicable, listing requirements³⁴² and trading conditions.
 - b) Ensure that access to the system or exchange is fair and objective, and oversee the related admission criteria and procedures.

Execution Procedures

4. The order execution rules should be disclosed to the regulator and to market participants, and should be applied fairly to all participants.³⁴³ The exchange or trading system's order routing procedures also should be clearly disclosed to the regulator and to market participants, applied fairly and should not be inconsistent with relevant securities regulation (e.g., client precedence or prohibition of front running or trading ahead of customers).³⁴⁴

Trading Information

5. Information on completed transactions, trading information and rules and operating procedures should be available, and the regulator should verify that it is provided on an equitable basis to all similarly situated market participants.
 - a) Any categorization of participants, for the purpose of access to pre-trade information, should be made on a reasonable basis.
 - b) Any differential access to such information should not unfairly disadvantage specific categories of participants.
6. Full trade documentation and an audit trail should be available to the regulator.

³⁴² See Section E on Issuers, Book 1.

³⁴³ Principles, Section 13.3 bullet point 7 on Trade Execution.

³⁴⁴ Principles, Section 13.3 bullet point 6 on Routing of Orders.

Key Questions

Exchanges or Trading Systems, Subject to Regulation

1. Does the establishment of an exchange or trading system³⁴⁵ require authorization?
2. Are there criteria for the authorization³⁴⁶ of exchange and trading system operators that:
 - a) Require analysis and authorization of the market by a competent authority?
 - b) Seek evidence of operational or other competence of the operator of an exchange or trading system as a secondary market?³⁴⁷
 - c) Require the operator of an exchange or trading system that assumes principal, settlement, guarantee or performance risk to comply with prudential and other requirements designed to reduce the risk of non-completion of transactions (*e.g.*, mandatory margin assessment and collection, capital or financial resources, member contributions, guaranty fund, credit or position limits)?
 - d) Permit the regulator to impose ongoing conditions (as appropriate) on the operator of an authorized exchange or regulated trading system, such as the obligation to establish rules, policies and procedures to prevent fraudulent behavior, treat all members or participants fairly, and have the capacity to carry out the market's and the competent authority's obligations?³⁴⁸

*Supervision*³⁴⁹

3. Does regulation require an assessment of:
 - a) The reliability of all arrangements made by the operator for the monitoring, surveillance and supervision of an exchange or trading system and its members or participants to ensure fairness, efficiency, transparency

³⁴⁵ To the extent a trading system is treated as a broker the applicable requirements under these Principles would be those related to market intermediaries, coupled with any transparency, insider trading or market abuse requirements.

³⁴⁶ The term “authorization” should be interpreted to include “licensed,” “granted authority to do investment business” or “recognition.”

³⁴⁷ Principles, Section 13.3.

³⁴⁸ IOSCO Public Document No. 90, *Supervisory Framework for Markets*, IOSCO Technical Committee (May 1999) states at page 7: “Through the authorization process, the regulator retains an important enforcement tool: the ability to prohibit or place restrictions upon operations.” This is implicit in the concept of being “accountable”.

³⁴⁹ *Id.*, pages 8 and 9.

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and investor protection, as well as compliance with securities legislation?³⁵⁰

- b) The market's dispute resolution and appeal procedures or arrangements as appropriate, its technical systems standards and procedures related to operational failure, information on its record keeping system, reports of suspected breaches of law, arrangements for holding client funds and securities, if applicable, and information on how trades are cleared and settled?
- c) The mechanisms that must be in place to identify and address disorderly trading conditions and to deal with any contravening conduct that is detected,³⁵¹ including details of procedures for trading halts,³⁵² other trading limitations and assistance available to the regulator in circumstances of potential trading disruption on the system?³⁵³

Securities and Market Participants

- 4. With respect to securities and market participants:
 - a) Is the regulator informed of the types of securities to be traded and does it approve the rules governing the admission of the securities to trading or listing?³⁵⁴
 - b) Where applicable, does the regulator or the market take product design³⁵⁵ and trading conditions into account in order to admit a product for trading?³⁵⁶
 - c) Does the regulatory framework provide for fair access³⁵⁷ to the exchange or trading system through oversight of the related rules for participation?³⁵⁸

³⁵⁰ Principles, Section 13.3.

³⁵¹ Principles, Section 13.3 bullet point 9 on Supervision of System and Participants by the Operator.

³⁵² See *Indexation: Securities Indices and Index Derivatives*. (February 2003). pp. 28-29: "More aggressive surveillance can be applied to supplement the design characteristics inherent in non-diversified indices..."

³⁵³ Principles, Section 13.3 on Trading Disruptions.

³⁵⁴ Principles, Section 13.3.

³⁵⁵ Securities may be subject to rules or requirements for admission to public trading. Principles, Section 13.3 bullet point 3 on Admission of Products to Trading. See also IOSCO Public Document No. 85, *The Application of the Tokyo Communiqué to Exchange-Traded Financial Derivatives Contracts* (September 1998). In the case of derivatives, "Contract design rules for derivatives markets should be viewed as a complement to an appropriate surveillance system. In general, contract design standards are intended to assure that contracts are not readily susceptible to manipulation, that the delivery and/or settlement mechanism is reliable, and (for derivative products) that the prices of the underlying and the derivative converge at expiration and, as a consequence, can serve a valid risk management function." See also Section E, Principles Relating to Issuers.

³⁵⁶ Principles, Section 13.3, bullet point 3 on Admission of Products to Trading.

³⁵⁷ Principles, Section 13.3, bullet point 4 on Admission of Participants to Trading System. For example, with respect to access to electronic systems for derivative products, do rules ensure that: response time is

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Fairness of Order Execution Procedures

5. With respect to fairness of order execution procedures:
 - a) Are order routing procedures clearly disclosed, applied fairly and not inconsistent with relevant securities regulation (e.g., requirements with respect to precedence of client orders and prohibition of front-running or trading ahead of customers)?³⁵⁹
 - b) Are execution rules disclosed to the regulator and to market participants, and consistently applied to all participants?³⁶⁰
 - c) Where applicable, does the regulator review the trade matching or execution algorithm of automated trading systems for fairness?³⁶¹

Operational Information

6. With respect to trading information:
 - a) Do similarly situated market participants have equitable access to market rules and operating procedures?³⁶²
 - b) Are there adequate arrangements for transparency?³⁶³
 - c) Are adequate records (i.e., audit trails) available to reconstruct trading activity within a reasonable time?
 - d) Is the system capable of disclosing the types of information that it is designed to make available, and, conversely, of providing safeguards to

equivalent for all system participants; all similarly situated system users have an equal ability to connect and to maintain the connection to the system; all equivalent “inputs” (e.g., volume and order type) by system users are treated fairly and equally; and access by links or interfaces with other systems (e.g., clearing systems, order routing systems, quotation vendors) are equitable? *See also* the discussion of Principle 3 in IOSCO Public Document No. 4, *Screen-Based Trading Systems for Derivative Products*, IOSCO Technical Committee (June 1990). These are illustrative “best practices” developed in the context of regulated trading systems for derivative products and are not intended to limit or define practices for regulated trading systems for other securities products.

³⁵⁸ Principles, Section 13.3.

³⁵⁹ Principles, Section 13.3. Regulatory issues may depend on whether orders are transmitted to an organized regulated market or to other regulated trade execution and matching systems. *See also* the discussion in paragraphs 67-73 of IOSCO Public Document No. 42, *Issues in the Regulation of Cross-Border Proprietary Screen-Based Trading Systems*, IOSCO Technical Committee (October 1994).

³⁶⁰ Principles, Section 13.3.

³⁶¹ *Screen-Based Trading Systems for Derivative Products*.

³⁶² Principles, Section 13.3.

³⁶³ Principle 27.

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preserve the confidentiality of other information, the disclosure of which is not intended?³⁶⁴

Benchmarks

Fully Implemented

Requires affirmative responses to all applicable Questions.

Broadly Implemented

Requires affirmative responses to all applicable Questions except to Question 3(b) in so far as it pertains to dispute resolution or applicable appellate procedures, and to Questions 4(b) and 5(c).

Partly Implemented

Requires affirmative responses to all applicable Questions except to Questions 2(d), 4(b), 5(b), 5(c) and 6(b) and Question 3(b) as otherwise permitted under “*Broadly Implemented*.”

Not Implemented

Inability to respond affirmatively to one or more of Questions 1, 2(a), 2(b), 2(c), 3(a), 3(b) subject to the departures set forth in “*Broadly Implemented*” above, 3(c) 4(a), 4(c), 5(a), 6(a), 6(c) or 6(d).

Explanatory Notes

Some jurisdictions use a combination of intermediary and market regulation for trading systems. The assessor should determine how to apply the benchmarks when such combinations of regulatory programs are used. For example, some trading systems, dealer-type systems or systems with direct retail customer access, may be regulated under intermediary principles, subject to adequate transparency arrangements and market abuse prohibitions and surveillance. This observation also applies to Principles 26 and 27.

A regulator may recognize an exchange or trading system established in another jurisdiction based on the equivalence or comparability of the regulation applicable to the market in its domestic jurisdiction consistent with these Principles. In cases of multiple markets, the assessor will be required to form a judgment about the criteria applied by the regulator having due regard to the volume of trading and turnover and the related importance of the market.

Assessors should consider a Principle to be *Not Applicable* whenever it does not apply given the nature of the securities market in the given jurisdiction (where there is no

³⁶⁴ Principles, Section 13.3, bullet point 5 on Provision of Trading Information. See also the discussion of Principle 2 in *Screen-Based Trading Systems for Derivative Products*, supra.

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operating exchange or trading system established or operating within the jurisdiction) and relevant structural, legal and institutional considerations. In such a case, the reason for the determination should be documented.

Principle 26 There should be ongoing regulatory supervision of exchanges and trading systems, which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.

Orderly smooth functioning markets promote investor confidence. Accordingly, there should be ongoing supervision of the markets.³⁶⁵

Key Issues³⁶⁶

1. The regulator must remain satisfied that the conditions thought to be necessary pre-requisites of authorization remain in place during operation.
2. Amendments to the rules of the authorized exchange or regulated trading system should be provided to, or approved by, the regulator.
3. Authorization of the authorized exchange or regulated trading system should be re-examined, or withdrawn, when it is determined that the system is unable to comply with the conditions of its authorization or with securities law or regulation.

Key Questions

1. Does the regulatory system include:
 - a) A program whereby the regulator or an SRO, subject to oversight by the regulator, monitors day-to-day trading activity on the exchange or trading system (through a market surveillance program), monitors conduct of market intermediaries (through examinations of business operations) and collects and analyzes the information gathered through these activities?³⁶⁷
 - b) Regulatory oversight mechanisms to verify compliance by the exchange or trading system with its statutory or administrative responsibilities, particularly as they relate to the integrity of the markets, market surveillance, the monitoring of risks, and the ability to respond to such risks?³⁶⁸

³⁶⁵ *Supervisory Framework for Markets*, supra, at page 3.

³⁶⁶ Principles, Section 13.4.

³⁶⁷ *Supervisory Framework for Markets*, supra, at page 9.

³⁶⁸ Such information can be provided through formal mechanisms, such as written reports and inspections, or through informal mechanisms such as regular meetings. *Supervisory Framework for Markets*, supra, at page 9.

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- c) Provides the regulator with adequate access to all pre-trade and post-trade information available to market participants?
2. Does the regulatory framework require that amendments to the rules of the exchange or trading system must be provided to, or approved by, the regulator?³⁶⁹
3. When the regulator determines that the exchange or trading system is unable to comply with the conditions of its approval, or with securities law or regulation, is there a mechanism that permits the regulator³⁷⁰ to:
 - a) Re-examine the exchange or trading system and impose a range of actions, such as restrictions or conditions on the market operator?
 - b) Withdraw the exchange or trading system's authorization?

Benchmarks

Fully Implemented

Requires affirmative responses to all applicable Questions.

Broadly Implemented

Requires affirmative responses to all applicable Questions except to Question 3(a).

Partly Implemented

Requires affirmative responses to all applicable Questions except to Questions 2 and 3(a).

Not Implemented

Inability to respond affirmatively to one more of Questions 1(a), 1(b), 1(c) or 3(b).

Explanatory Notes

Question 3(a) gives more content to the phrase “reexamine the market’s authorization.” “Since license revocation is such a serious disciplinary action, in many cases market operators will not believe it would ever be used and therefore it may not be an effective deterrent. The regulator also should have the clear power to impose an escalating range of disciplinary actions, such as conditions or restrictions on the market operator. While imposition of these restrictions should be subject to some procedural fairness conditions, the process must not be so slow or cumbersome as to prevent regulators acting swiftly

³⁶⁹ Principles, Section 13.4.

³⁷⁰ Id.

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and effectively when required.”³⁷¹ If not, the regulator should be invited to discuss how revocation authority can be used to buttress its ability to use moral suasion to achieve corrective action.

³⁷¹ *Supervisory Framework for Markets*, supra, at page 7.

Principle 27 Regulation should promote transparency of trading.

Transparency may be defined as the degree to which information about trading (both for pre-trade and post-trade information) is made publicly available on a real-time basis. Pre-trade information concerns the posting of firm bids and offers, in both quote and order-driven markets, as a means to enable intermediaries and investors to know, with some degree of certainty, whether, and at what, prices they can deal. Post-trade information is related to the prices and volume of all individual transactions actually concluded.³⁷²

Market transparency is generally regarded as central to both the fairness and efficiency of a market, and in particular to its liquidity and quality of price-formation. The wide availability of information on bids and offers is a central factor in ensuring price discovery and in strengthening users' confidence that they will be able to trade at fair prices. This confidence should, in turn, increase the incentive of buyers and sellers to participate, facilitate liquidity and stimulate competitive pricing.

Information in respect to the volumes and prices of completed trades enables market participants and their customers not only to take into account the most recent information on volumes and prices but also to monitor the quality of executions they have obtained compared with other market users.

In general, the more complete and more widely available trading information is, the more efficient the price discovery process should be, and the greater the public's confidence in its fairness. However, establishing market transparency standards is not straightforward, as the interest of individual market participants and their customers in transparency levels varies. Regulators need to assess the appropriate level of transparency of any particular market structure with considerable care.³⁷³

Key Issues

1. Ensuring timely access to information is a key to the regulation of secondary market trading. Timely access to relevant information about secondary market trading allows investors to assess the terms on which they can trade, and the quality of the execution that they receive, and thereby to look after their own

³⁷² Principles, Sections 4.2.2 and 13.5 ¶ 1. For purposes of the Principles, transparency has largely been addressed from the perspective of equity markets with material retail involvement.

³⁷³ IOSCO Public Document No. 124, *Transparency and Market Fragmentation*, IOSCO Technical Committee (2001), at pages 4-5.

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- interests, and also reduces the potential for manipulative or other unfair trading practices.³⁷⁴
2. Information on completed transactions should be provided on an equitable basis to all participants.
 3. Where a market operator permits some derogation from the objective of real time transparency, the conditions should be clearly defined and the market authority (being either, or both, the exchange operator and the regulator) should have access to the complete information to be able to assess the need for derogation and, if necessary, to prescribe alternatives.

Key Questions

1. Does the regulatory framework include:
 - a) Requirements or arrangements for providing pre-trade (e.g., posting of bids and offers) and post-trade (e.g., last sale price and volume of transaction) information to market participants on a timely basis?
 - b) Requirements or arrangements that information on completed transactions be provided on an equitable basis to all participants?³⁷⁵
2. Where an authorized exchange or trading system's operator permits derogation from the objective of real-time transparency, are:
 - a) The conditions clearly defined?
 - b) Does the operator and/or the regulator have access to the complete information to be able to assess the need for derogation and if necessary, to prescribe alternatives?

Benchmarks

Fully Implemented

Requires affirmative responses to all applicable Questions.

Broadly Implemented

Requires affirmative responses to all applicable Questions except that with respect to Question 1(a), pre-trade information and information on

³⁷⁴ Discussed in IOSCO Public Document No. 27, *Transparency on Secondary Markets: A synthesis of the IOSCO Debate*, IOSCO Technical Committee (December 1992), in Sections 3 and 4 on the content of information.

³⁷⁵ Equitable access supports price formation but does not necessarily mean equal access for all classes of customers.

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completed trades in a primarily institutional trading market are not available on a timely basis.

Partly Implemented

Requires affirmative responses to all applicable Questions except to Question 1(a) as specified above and Question 1(b) post-trade information is not available on an equitable basis to all participants in an institutional market.

Not Implemented

Inability to respond affirmatively to one or more of Questions 1(a), 1(b), 2(a) or 2(b), if applicable, subject to the departures permitted above or post trade information on concluded transactions is not available either on a timely or on an equitable basis in a market accessible to retail investors.

Explanatory Notes

The degree of transparency of a market can be measured as a deviation from a real-time standard. However, there is no single standard of “timeliness.” Most exchanges and regulatory systems provide for a certain degree of deviation from a real-time standard, such as, permitting some degree of opaqueness of quote information for block transactions, adopting different definitions of “real-time,” adopting a “promptness” standard that varies from several minutes to a longer time, allowing exceptions to real-time based on the size of the trade, type of trade (dealer mediated rather than auction market) or type of dealer. Indeed, each type of market microstructure delivers market fairness, efficiency and transparency in slightly different ways.

Any derogation to the general requirements relating to post-trade transparency should be explained. Reasonable derogations should not prompt the assignment of the jurisdiction to a lower assessment category but should be documented. For markets whose participants are largely institutional investors, derogations to post-trade transparency requirements may be appropriate for large orders that expose intermediaries to risk and could affect the integrity of the price formation process, liquidity, or the orderly conduct of the market.

In the end, the final approach to transparency – and the degree of timeliness – is a policy decision, taken at the level of each individual country, on how to weigh the conflicting interests of the different market players (small investors, institutions, intermediaries and exchanges).³⁷⁶ The regulator should provide information as to the basis for these decisions and as to how they meet the objectives stated in the Key Issues.

In practice, except for wholesale and certain over-the-counter transaction venues, most markets seek to have post-trade price reporting and publication as close as possible to

³⁷⁶ *Transparency on Secondary Markets: A synthesis of the IOSCO Debate*, supra, at pages 23-24 and 30.

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real-time. Assessments are focused on regulated/organized markets, but any assessment must consider the prevailing structure of markets within the jurisdiction when addressing transparency.

Principle 28 Regulation should be designed to detect and deter manipulation and other unfair trading practices.

Market manipulation, misleading conduct, insider trading and other fraudulent or deceptive conduct may distort the price discovery system, distort prices and unfairly disadvantage investors.³⁷⁷

Such conduct should be addressed by direct surveillance, inspection, reporting, product design requirements, position limits, settlement price rules or market halts complemented by vigorous enforcement of the law and trading rules.³⁷⁸

An effective market oversight program should have a mechanism for monitoring compliance with the securities laws, regulations and market rules, operational competence requirements, and market standards.

Key Issues

1. The regulation of trading in secondary markets should prohibit market manipulation, misleading conduct, insider trading and other fraudulent or deceptive conduct and apply adequate, proportionate and dissuasive sanctions.³⁷⁹
2. The regulator should ensure that there are in place arrangements for the continuous monitoring of trading. These arrangements should trigger inquiry whenever unusual and potentially improper trading occurs.³⁸⁰
3. Regulation should cover cross-market conduct where, for example, the price of an equity product could be manipulated through the trading of options, warrants or other derivative products.³⁸¹
4. There must be adequate information sharing between relevant regulatory authorities, sufficient to ensure effective enforcement.³⁸²

³⁷⁷ Principles, Section 13.6 ¶ 1. See also IOSCO Public Document No. 103, *Investigating and Prosecuting Market Manipulation*, IOSCO Technical Committee (May 2000).

³⁷⁸ Principles, Section 13.6 ¶ 2. See also *The Application of the Tokyo Communiqué to Exchange-Traded Financial Derivatives Contracts*, supra.

³⁷⁹ Principles, Section 13.6 ¶ 1. See also *Investigating and Prosecuting Market Manipulation*, supra. See also Principle 9 and Principle 10.

³⁸⁰ Principles, Section 13.6 ¶ 3.

³⁸¹ Principles, Section 13.6 ¶s 4 and 5.

³⁸² Principles, Section 13.6 ¶ 6. See also *Indexation: Securities Indices and Index Derivatives*. (February 2003). pp. 35-40 regarding enhanced inter-market and cross-border cooperation.

Key Questions

1. Does the regulatory system prohibit the following with respect to securities admitted to trading on authorized exchanges and regulated trading systems:
 - a) Market or price manipulation?
 - b) Misleading information?
 - c) Insider trading?
 - d) Front running?
 - e) Other fraudulent or deceptive conduct and market abuses?
2. Does the regulatory approach to detect and deter such conduct include an effective and appropriate combination of:
 - a) Direct surveillance, inspection, reporting, such as, for example, securities listing or product design requirements (where applicable), position limits, audit trail requirements, quotation display rules, order handling rules, settlement price rules or market halts complemented by enforcement of the law and trading rules?
 - b) Effective, proportionate and dissuasive sanctions for violations?³⁸³
3. Are there arrangements in place for:
 - a) The continuous collection and analysis of information concerning trading activities?
 - b) Providing the results of such analysis to market and regulatory officials in a position to take remedial action if necessary?
 - c) Monitoring the conduct of market intermediaries participating in the market?
 - d) Triggering further inquiry as to suspicious transactions or patterns of trading?
4. If there is potential for domestic cross-market trading, are there inspection, assistance and information-sharing requirements or arrangements in place to monitor and/or address domestic cross-market trading abuses?
5. If there are foreign linkages, substantial foreign participation, or cross listings, are there cooperation arrangements with relevant foreign regulators and/or markets that address manipulation or other abusive trading practices?

³⁸³ Compare to requirements under Principles 8, 9 and 10.

Benchmarks

Fully Implemented

Requires affirmative responses to all applicable Questions.

Broadly Implemented

Requires affirmative responses to all applicable Questions except to Questions 4 and 5, provided that there is not substantial cross-border or cross-market activity and cooperation in fact occurs.

Partly Implemented

Requires affirmative responses to all applicable Questions except that if Questions 4 and 5 are applicable, there is evidence of cross-market and cross-border cooperation and information sharing, although no formal arrangements for cooperation may be in place.

Not Implemented

Inability to respond affirmatively to one or more of Questions 1(a), 1(b), 1(c), 1(d), 1(e), 2(a), 2(b), 3(a), 3(b), 3(c) or 3(d) or if Questions 4 or 5 are applicable, there is no evidence of cross-border cooperation whether or not there are formal arrangements for cooperation in place.

Explanatory Notes

Essential elements of monitoring compliance include: (1) monitoring the day-to-day trading activity in the markets (through a market surveillance program); (2) monitoring the conduct of market intermediaries (through examinations of business operations); and (3) collecting and analyzing information gathered from these activities.³⁸⁴ Techniques may differ for securities and derivatives markets. The regulator should be invited to explain how its approach operates to detect, deter and sanction misconduct.

The following are examples of some of the cases when cross-market surveillance information is relevant: When the underlying interest is traded in a jurisdiction other than the one where a derivative instrument is traded, or where identical financial products are traded in two jurisdictions, there may be increased potential for fraud or manipulation because of the difficulty of a regulator in one jurisdiction to monitor market activity directly or to conduct complete investigations of market activities in another jurisdiction.³⁸⁵

³⁸⁴ *Supervisory Framework for Markets*, supra, at page 9. See also Principles, Section 13.

³⁸⁵ *Supervisory Framework for Markets*, supra, at page 6.

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The regulator can make use of an exchange or trading system surveillance system provided that it has its own capacity to analyze and use the information directly to deter and detect market misconduct. This means that the regulator should have its own capacity to sort the information obtained from an exchange system.

Principle 29 Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.

Risk taking is essential to an active market and regulation should not unnecessarily stifle legitimate risk taking. Rather, regulators should promote and allow for the effective management of risk and ensure that capital and other prudential requirements are sufficient to address appropriate risk taking, allow the absorption of some losses and check excessive risk taking. An efficient and properly structured clearing and settlement process that is supervised and uses effective risk management tools is essential.³⁸⁶ The legal system also must support effective and legally secure arrangements for default handling. This is a matter that extends beyond securities law to the insolvency provisions of a jurisdiction. Insolvency law must support isolating risk, and retaining and applying margin previously paid into the system, notwithstanding a default or commencement of an administration or bankruptcy proceeding.

Instability may result from events that occur in another jurisdiction or occur across several jurisdictions, so regulators' responses to market disruptions should seek to facilitate stability domestically and globally through cooperation and information sharing.³⁸⁷

Key Issues

Monitoring of Large Positions

Market authorities³⁸⁸ should:

1. Have mechanisms to monitor open positions or credit exposures on unsettled trades that are sufficiently large to pose a risk to the market or to a clearing firm (i.e., large exposures)³⁸⁹ and for this purpose:
 - a) Establish trigger levels appropriate to their markets and continuously monitor the size of positions on their markets.³⁹⁰

³⁸⁶ Principle 30. See also Annex 6 on the Assessment Methodology for Securities Settlement Systems.

³⁸⁷ Principles, Section 4.2.3.

³⁸⁸ The term "market authority" is used, for purposes of large exposures, to refer to the authority in a jurisdiction that has statutory or regulatory powers with respect to the exercise of certain regulatory functions over a market. The relevant market authority, depending on the jurisdiction, may be a regulatory body, a self-regulatory organization, and/or the market itself. IOSCO Public Document No. 49, *Report on Cooperation Between Market Authorities and Default Procedures*, IOSCO Technical Committee (March 1996), at page 2.

³⁸⁹ For these purposes Large Exposures may be construed to be open unsettled positions; open short positions, margined positions, options and other derivatives. Principles, Section 13.7 ¶ 1, 2nd sentence.

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- b) Have access to information, if needed, on the size and beneficial ownership of positions held by direct customers of market intermediaries.³⁹¹
 - c) Have authority to take appropriate action where a direct market participant does not make requested market information available to the market authority.³⁹²
 - d) Have the power to take appropriate action, such as requiring the market participant to reduce exposures, increase margin, or deposit additional collateral.³⁹³
2. Promote mechanisms that facilitate the sharing of information on large exposures through appropriate channels.³⁹⁴

Default Procedures – Transparency and Effectiveness

3. Market authorities should make relevant information concerning market default procedures available to market participants.³⁹⁵
4. Regulators should ensure that the procedures relating to defaults, and permitted corrective actions, are effective and transparent.³⁹⁶
5. Market authorities for related products (cash or derivative) should consult with each other, as soon as practicable, with a view to minimizing the adverse effects of market disruptions.³⁹⁷

Key Questions

Monitoring of Large Positions

1. Does the market authority have a mechanism in place that is intended to monitor and evaluate continuously the risk of open positions or credit exposures that are sufficiently large to expose a risk to the market or to a clearing firm that includes:
 - a) Qualitative or quantitative trigger levels appropriate to the market for the purpose of identifying large exposures, continuous monitoring and an evaluative process?³⁹⁸

³⁹⁰ Principles, Section 13.7 ¶ 3, 1st sentence. The assessor should request empirical evidence of an evaluative procedure before concluding that there is effective ongoing monitoring. See also *Report on Cooperation between Market Authorities and Default Procedures*, supra, at page 3 ¶ 6.

³⁹¹ Principles, Section 13.7 ¶ 3, 2nd sentence.

³⁹² Principles, Section 13.7 ¶ 4.

³⁹³ Principles, Section 13.7 ¶ 3, 3rd sentence.

³⁹⁴ Principles, Section 13.7 ¶ 2.

³⁹⁵ Principles, Section 13.7 ¶ 5.

³⁹⁶ Principles, Section 13.7 ¶ 6.

³⁹⁷ Principles, Section 13.7 ¶ 7.

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- b) Access to information, if needed, on the size and beneficial ownership of positions held by direct customers of market intermediaries?³⁹⁹
 - c) The power to take appropriate action against a market participant that does not provide relevant information needed to evaluate an exposure (e.g., require liquidation of positions, increase margin requirements and/or revoke trading privileges)?⁴⁰⁰
 - d) The general power to take appropriate action, such as to compel market participants carrying or controlling large positions to reduce their exposures or to post increased margin?⁴⁰¹
2. Do arrangements, whether formal or informal, exist to enable markets and regulators to share information on large exposures of common market participants or on related products with regulators and markets:
 - a) In the domestic jurisdiction?
 - b) In other relevant jurisdictions?⁴⁰²

Default Procedures – Transparency and Effectiveness

3. Does a market authority make its default procedures available to market participants, including specifically information concerning:
 - a) The general circumstances in which action may be taken?
 - b) Who may take it?
 - c) The scope of actions which may be taken?⁴⁰³
4. Do default procedures and/or national law permit markets and/or the clearing and settlement system(s) promptly to isolate the problem of a failing firm by addressing its open proprietary positions and positions it holds on behalf of customers or otherwise protect customer funds and assets from an intermediary's default under national law?⁴⁰⁴

³⁹⁸ Principles, Section 13.7 ¶ 1. See also *Report on Cooperation Between Market Authorities and Default Procedures*, supra, at page 3 ¶ 4.

³⁹⁹ Principles, Section 13.7 ¶ 4.

⁴⁰⁰ Principles, Section 13.7 ¶ 2. See also *Report on Cooperation Between Market Authorities and Default Procedures*, supra, at page 4 ¶ 8.

⁴⁰¹ Principles, Section 13.7 ¶ 5.

⁴⁰² *Report on Cooperation Between Market Authorities and Default Procedures*, supra, at page 4 ¶ 8 regarding the promotion of formal/informal mechanisms. See also *Report on Trading Halts and Market Closures*. (October 2002). pp. 23-24.

⁴⁰³ Id, for a template or list of information that should be available to market participants as to market default procedures regarding futures and options transactions.

⁴⁰⁴ IOSCO Principles, Section 4.2 ¶ 3.

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5. Is there a mechanism by which market authorities for related products can consult with each other in order to minimize the adverse effects of market disruptions?

Benchmarks

Fully Implemented

Requires affirmative responses to all applicable Questions taking into account that the combination of mechanisms enumerated in Question 4 available in the jurisdiction are sufficient to reduce the impact of any failure and in particular to isolate risk to the failing institution.⁴⁰⁵

Broadly Implemented

Requires affirmative responses to all applicable Questions subject to an evaluation of the mechanisms in Question 4 and except to Questions 1(a), 3(a) and 5, provided that other measures are in place to address cross-market risks.⁴⁰⁶

Partly Implemented

Requires affirmative responses to all applicable Questions except to Questions 1(a) subject to departures permitted for *Partly*, 1(b), 1(c), 2 (b), 3(a) and 5.

Not Implemented

Inability to respond affirmatively to one or more of Questions 1(d), 2(a) if applicable, 3(b), 3(c) or 4 or bankruptcy or other relevant national law is uncertain or does not support isolation of risk to the failing firm and effective management of a disruption.

Explanatory Note

The insolvency system should support effective management of a firm's failure or market disruption. The regulator should identify any concerns with respect to applicable bankruptcy law.

For example, the following mechanisms can be relevant to addressing a financial failure or market disruption, however, other mechanisms also may be adequate if the objectives of isolating risk and protecting funds from being taken to cover the intermediary's default are achieved.

⁴⁰⁵ Principles Section 4.2.3 Also, responses to market disruption should seek to facilitate stability domestically and globally through cooperation and information sharing.

⁴⁰⁶ Exception reporting based on a surveillance program is consistent with the monitoring contemplated by Key Question 1(a).

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- National insolvency laws that specifically accommodate market default procedures.
- Central bank guarantees.
- The use of the defaulting firm's proprietary funds and assets to meet its obligations to market counterparties.
- The transfer or liquidation of customer positions at the defaulting firm under market rules without interference from bankruptcy law.⁴⁰⁷
- The transfer of customer funds and assets, or use of a guarantee system.
- Where customer positions or funds are to be transferred, arrangements for distinguishing firm and customer positions, deposits and accruals.

Assessments of Principle 29 should take account of any vulnerabilities in risk management identified with respect to Principle 30 and there should be close communication as to any findings under this Principle and those relating to clearing and settlement.

⁴⁰⁷ Liquidation is acceptable as in cases where the nature of the position makes transfer impracticable, or in cases where a customer may not have completed the documentation necessary for the transfer or the applicable regulation does not allow for transfers. See also *Report on Cooperation Between Market Authorities and Default Procedures*, supra, ¶6 (3). The market, however, should not be required to maintain open unsettled transactions once a direct participant has defaulted.

I. Principles Relating to Clearing and Settlement

1. *Preamble*

Principle 30 evidences IOSCO's conclusion that adequate clearing and settlement systems are essential to fair, efficient and transparent markets and the reduction of systemic risk. Clearance and settlement issues, therefore, are a critical component of the overall assessment of secondary markets regulation.

In assessing implementation of this Principle, it is important to take into consideration the role of the regulator, as discussed in Principles 1 through 5 and 8, particularly as it relates to the regulator's oversight and inspection powers regarding clearing and settlement activities. It is also important to consider Principle 24 regarding failure of market intermediaries and Principle 29 regarding regulatory measures to ensure the proper management of large exposures, default risk and market disruption. Both of these Principles are relevant to the reduction of systemic risk in clearing and settlement activities. Any conclusions regarding exposure to systemic risk under these Principles should be consistent with the risk analysis contemplated under Principle 30 and any assessment completed by an assessor of the CPSS/IOSCO Recommendations for Securities Settlement Systems and the associated assessment methodology. Such conclusions should also take into account any related assessment of the payment system in the assessed jurisdiction.

In performing a self-assessment, a jurisdiction should take into account the structure of the market in applying the guidance provided herein. If different assessors are assigned to assess securities regulation generally, and securities and settlement systems specifically, it is essential that they remain in close communication throughout the assessment process and that they share their respective work products in order to ensure consistency.

2. *Scope*

The clearing and settlement of transactions in securities, including futures and other derivatives of various types, involves a broad array of services and activities, such as trade matching services, trade confirmation services, distribution of cash flows, central counterparty arrangements, services related to the issuance of settlement instructions, processing of settlements of securities and funds, and custodian and other services. The nature, attributes and organization of these services and activities may vary depending on the type of security or other financial instrument or contract that is the subject of the transaction being cleared and settled.

Clearing and settlement systems may differ structurally in accordance with the market or combination of markets and instruments covered. Principle 30 is intended to apply to all material securities clearing and settlement activities in a jurisdiction, regardless of the type of instrument being cleared and settled. Consequently, included within its scope are

clearing and settlement arrangements for equities, government bonds, corporate bonds, options and futures.

3. *Principle 30*

Principle 30 Systems for clearing and settlement of securities transactions should be subject to regulatory oversight, and designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.

In November 2001, subsequent to the adoption of the Principles, the IOSCO Technical Committee and the Committee on Payment and Settlement Systems (CPSS/IOSCO Task Force) issued *Recommendations for Securities Settlement Systems* (RSSS). The CPSS/IOSCO Task Force also has adopted a comprehensive assessment methodology for purposes of assessing implementation of the Task Force's Recommendations by IOSCO member jurisdictions, a copy of which is included in Annex 6 of Book II of this Methodology. The CPSS/IOSCO Recommendations and assessment methodology should be viewed as a more detailed articulation of Principle 30 that should be applied to address any issues in such Recommendations that are also covered by Principle 30.⁴⁰⁸

Accordingly, a separate set of clearing and settlement Key Questions and benchmarks for Principle 30 is not included in this Methodology. Any self-assessment or third party assessment of a securities clearing and settlement system within a jurisdiction should be made using the CPSS/IOSCO assessment methodology included in Annex 6 and incorporated herein by reference. An assessor should use all applicable Key Issues, Key Questions and related benchmarks in the CPSS/IOSCO assessment methodology.

The assessment should take into account the peculiar structure of the market assessed. There are jurisdictions where an authorized exchange or regulated trading system deals in securities as well as derivatives products where those instruments are cleared on the same system and there are jurisdictions where there are specialized trading and/or clearing systems for derivatives products. The CPSS/IOSCO securities settlement assessment methodology explicitly recognizes that where derivatives are settled through a central counterparty that also acts as a central counterparty for securities, the assessment may need to address the central counterparty's treatment of derivatives risks. In such a case the CPSS/IOSCO methodology may not cover all the Key Issues envisaged under Principle 30.⁴⁰⁹

Table 1 includes a list of Key Issues that are comprehended by Principle 30 and cross references these to the corresponding Key Questions in the CPSS/IOSCO assessment methodology. Any assessment of clearing and settlement for those markets, which trade

⁴⁰⁸ The concordance included in Annex 2-4 of Part II indicates the CPSS/IOSCO Recommendations that correspond to Principles, Sections 13.8 through 13.11.3 and where there are additional issues referred to in Principle 30.

⁴⁰⁹ See the Concordance in Annex 2-4.

derivatives as well as securities, should encompass clearing and settlement of derivatives as well as securities if the derivatives risks are material (ie., of economic significance) to an overall assessment. The CPSS/IOSCO assessment methodology should be used for such purposes and, where securities and derivatives are cleared on one system, that assessment methodology may be sufficient. An assessor nonetheless may note any additional risks, taking into account the Concordance and the Key Questions below.

However, where derivatives traded on an authorized exchange or regulated trading system are cleared through a separate system,⁴¹⁰ the assessor should use the Table below and the additional questions, which may not be exhaustive.

Table I
Key Issues under Principle 30 with cross references to corresponding Key Questions in the CPSS/IOSCO Assessment Methodology

Principle 30 Key Issues⁴¹¹	CPSS/IOSCO Key Questions⁴¹²
1. The rules and operating procedures governing the clearing and settlement systems should be available to market participants.	Recommendation 1, Key Questions 1 and 4 Recommendation 17, Key Questions 1-4
2. There should be direct supervision of clearing and settlement systems and their operators.	Recommendation 10, Key Question 2 Recommendation 12, Key Question 3 Recommendation 18, Key Questions 1-3
3. Regulators of clearing and settlement organizations should require a framework that permits them to ensure the accountability of such systems, to monitor and, if possible, detect and foresee and to prevent or mitigate problems associated with clearance and settlement. Regulators should be empowered to issue	Recommendation 1, Key Questions 2(ii) and 3 Recommendation 3, Key Question 3 Recommendation 4, Key Questions 2-4 Recommendation 7, Key Question 1 Recommendation 8, Key Question 3 Recommendation 9, Key Questions 1-3 Recommendation 11, Key Questions 1-4

⁴¹⁰ This is due, in part, to the fact that the work of the CPSS/IOSCO Task Force is ongoing. For example, paragraph 2.3 of the CPSS/IOSCO assessment methodology indicates: "Even if all securities traded in a country are settled through the same SSS, derivatives may be settled through a separate system. Exchange-traded derivatives are nearly always cleared and settled through a CCP [central counterparty], which may be organized as a department of the exchange or as a separate legal entity. Where it is a separate legal entity, that entity may act as CCP for multiple derivatives exchanges and possibly also for securities trades. The RSSS were not designed to be applied to derivatives and do not address comprehensively the risks they face or the risk management procedures they typically employ. Nonetheless, many of the recommendations, notably those on CCPs, legal framework, operational reliability, governance, access, transparency, and regulation and oversight, are relevant to clearance and settlement of exchange-traded derivatives. Where derivatives are settled through a CCP that also acts as counterparty to securities trades, the assessment of the SSS for those securities may need to address the CCP's management of risks with respect to those derivatives transactions. This is especially the case if collateral requirements and financial support arrangements apply to portfolios that include both securities and derivatives. But the recommendations need not be applied to exchange-traded derivatives that are cleared and settled by a separate CCP. In the future, international standards that would be applicable to CCPs for both securities and derivatives may need to be developed." In February 2003, the IOSCO Technical Committee authorized the Task Force to develop standards for CCPs that will apply to both securities and derivatives transactions.

⁴¹¹ Principles, Sections 13.9-13.11.3

⁴¹² The CPSS/IOSCO Recommendations and Key Questions are in Annex 6, Part II.

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directions which the clearing and settlement systems or their operators must satisfy.	Recommendation 12, Key Question 1, last sentence Recommendation 18, Key Question 3 Recommendation 19, Key Questions 1-3
4. The operation of clearing and settlement services should be subject to inspection and periodic review by the regulator. The clearing and settlement organizations should be required to report to the regulator and may be required to submit to periodic and, if necessary, special audits and examinations.	Recommendation 3, Key Question 3 Recommendation 5, Key Question 3 Recommendation 10, Key Question 2 Recommendation 12, Key Questions 1-2 Recommendation 18, Key Questions 1-3
5. The arrangements for clearing and settlement systems should provide for the expeditious verification and settlement of a trade, finality by the end of the settlement period, delivery versus payment between direct participants and reduction of market risk, credit risk, funding liquidity and operational risk consistent with international standards.	Recommendation 2, Key Questions 1-3 Recommendation 3, Key Questions 1-4 Recommendation 4, Key Questions 1-4 Recommendation 5, Key Questions 1-3 Recommendation 8, Key Questions 1-3 Recommendation 9, Key Questions 1-3 Recommendation 10, Key Questions 1-4 Recommendation 16, Key Question 1 Recommendation 19, Key Questions 1-3
6. There should be procedures to identify and monitor risks on an on-going basis, including risks posed by clearing participants.	Recommendation 3, Key Question 3 Recommendation 4, Key Questions 3-4 Recommendation 5, Key Question 3 Recommendation 9, Key Questions 1, 2 and 3 Recommendation 10; Key Questions 1-2 Recommendation 11, Key Questions 1-3 Recommendation 12, Key Question 2 Recommendation 19, Key Questions 1 and 3
7. Derivatives settlement systems should be symmetric to avoid liquidity risk. Pays and collects should be handled contemporaneously.	No directly corresponding provision
8. Margin and other requirements should be designed so that sufficient funding is available to cover likely trading exposures (both as to extent and duration) to avoid gridlock. The adequacy of margin and other requirements should periodically be reviewed by competent market authorities.	Recommendation 3, Key Question 3 Recommendation 4, Key Question 3 Recommendation 9, Key Questions 1 and 2 Recommendation 12, Key Question 1 Key Questions not designed to address all margin issues pertaining to derivatives, such as futures
9. Appropriate protections should be in place to prevent undue risks related to actual handling of securities and deliveries, including short sales and stock loans of the underlying securities.	Recommendation 1, Key Questions 2(ii)(c) and (e) Recommendation 4, Key Question 3 Recommendation 5, Key Questions 1-3 Recommendation 6, Key Question 1 Recommendation 7, Key Questions 1-2 Recommendation 8, Key Questions 1 and 3 Recommendation 9, Key Questions 1 and 2 Recommendation 12, Key Question 1 Recommendation 19, Key Questions 1-3
10. The legal frameworks should assure access to collateral, timing of self-assessment, legality of netting and novation, settlement finality, delivery versus payment, liquidity of arrangements and reduction of risk consistent with international standards and the complexity of the relevant clearing systems.	Recommendation 1, Key Questions 2-4 Recommendation 4, Key Questions 2-3 Recommendation 5, Key Question 1 Recommendation 8, Key Question 3 Recommendation 10, Key Question 2 Recommendation 12, Key Question 1 Recommendation 18, Key Question 3

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As reflected both in Table I and in the concordance in Annex 2-4, there is at least one Key Issue (7) relating to clearance and settlement of derivatives transactions under Principle 30 that is not addressed specifically in the CPSS/IOSCO Recommendations or assessment methodology. Settlement of derivatives transactions on regulated or authorized exchange markets normally involves daily (or more frequent) cash settlement of profits and losses, in which case the settlement systems should be symmetric to avoid liquidity risk, and pays and collects should be handled contemporaneously.⁴¹³ Similarly, cash settlement of derivatives transactions has enabled settlement in most derivatives markets to occur at T+1 or less while T+3 remains the norm for settlement in many securities markets. There are other Principle 30 Key Issues, such as Key Issue 8 relating to margin, for which the corresponding Key Questions in the CPSS/IOSCO Methodology are not intended to apply primarily to clearance and settlement of derivatives transactions, such as futures transactions. Therefore, the current CPSS/IOSCO methodology is not exhaustive. For example, futures markets generally use CCPs to clear and settle transactions. CPSS/IOSCO has acknowledged that risk management measures must be tailored to the risk of such systems and that the CPSS/IOSCO methodology does not comprehensively treat CCPs.⁴¹⁴ The IOSCO Principles also are primarily directed at authorized exchanges and regulated trading systems. They have not been designed, nor has this Principle 30 been designed to address comprehensively the risks related to clearing over-the-counter derivatives products

Other questions also may arise that are unique to derivatives clearing and settlement. Pending further guidance from the CPSS/IOSCO Task Force, the assessor should consult the discussion under Principles, Section 13.11 as well as other relevant IOSCO reports.⁴¹⁵ In addition to the CPSS/IOSCO guidance cited in Table I, issues similar to those addressed in Key Issues 3, 2nd sentence, 4, 5, 6 and 8 are treated under Principle 29. An assessor also should bear in mind that certain risk monitoring and control issues relevant to clearance and settlement systems for derivatives transactions, such as margining (Principles, Section 13.11.1) and short selling and securities lending (Principles, Section 13.11.3), are also addressed in the methodology for Principle 29.

For purposes of assessing a derivatives' clearing and settlement system or any clearing and settlement system of which derivatives risk is a component or clearing is handled through a central counterparty, the following questions also should be considered:

⁴¹³ Principles, Section 13.11 ¶5.

⁴¹⁴ See IOSCO/CPSS Recommendation 4, and note 2 *supra*, indicating that the IOSCO Technical Committee in February 2003 authorized the Task Force to develop standards for CCPs that will apply to both securities and derivatives transactions.

⁴¹⁵ E.g., information regarding Key Issues 3, 2nd sentence, 5, 6 and 8 may be found in: *Report on Cooperation between Market Authorities and Default Procedures*, *supra*; IOSCO Public Document No. 50, *Report on Margin*, IOSCO Technical Committee, March 1996; IOSCO Public Document No. 22, *Coordination Between Cash and Derivative Markets – Contract Design of Derivative Products on Stock Indices and Measures to Minimize Market Disruption*, October 1992; and IOSCO Public Document No. 96, *Securities Lending Transactions: Market Development and Implications*, Joint Report by the IOSCO Technical Committee and the Committee on Payment and Settlement Systems of the Bank for International Settlements, July 1999.

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1. Are settlement systems for derivatives symmetric, that is, are pays and collects handled fairly contemporaneously subject to collateral requirements?
2. Are margin or other requirements designed so that sufficient funding is available to cover likely trading exposures? Are margin requirements periodically reviewed as to adequacy by the competent authorities?
3. Are the arrangements for addressing the risk of handling delivery of securities, including short sales and loans of underlying or relevant securities sufficient?

With respect to evaluating the treatment of gains and losses on positions cleared through a derivatives clearing system:

- Payment flows in the context of derivatives settlement systems may occur in the context of settlement variations where gains or losses on futures positions are resolved, and in the context of margining requirements. Payment flows as a result of settlement variation obligations should be perfectly symmetric such that the settlement losses of clearing members can be applied against the settlement gains of other clearing members contemporaneously.
- A symmetric system involves the computation of settlement variation gains and losses, and generation of payment calls on the clearing members obliged to pay on their positions. Simultaneously, clearing members entitled to receive payment on their positions have their accounts credited by the same amounts. By doing so, the clearing house need not assume any principal risk.

It is recognized that the settlement of margin calls relates to margin requirements on clearing members which may change under different market conditions or as the result of different levels of exposure. In a more volatile market, margin calls may result in a net inflow of funds for the clearing house unless open interest declines. In such cases, pays and collects (for withdrawals of excess margin and inflows for additional margins required) in regard to margin calls which are effected contemporaneously will reduce (but are unlikely to eliminate) liquidity risks.

It is also possible for the settlement of settlement variation and margin calls payment flows to be combined. In this case, excess margin collateral, for example, could be applied against any settlement variation losses. This has the effect of netting opposite payment flows from settlement variation and margin calls, thereby reducing liquidity requirements. Settlement variation and margin calls instructions in such cases could be combined.

Rather than benchmarking Principle 30 separately, if an IOSCO assessor has a specific question about vulnerabilities not addressed by the CPSS/IOSCO methodology, the assessor should communicate that to the assessed jurisdiction by comment and also to any settlement assessor. If answers to the Key Questions noted here are not in the affirmative, any assessment also should identify and explain resulting vulnerabilities as a

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*comment. In so doing, the regulator should be encouraged to describe how its system takes into account the complexity of the system(s) being addressed.*⁴¹⁶

⁴¹⁶ Cf. Principles, Section 13.11.1. For example, cross margining arrangements, linkage arrangements, clearing of over-the-counter products, cross-border clearing, et cetera. If a derivatives clearing system is separate from the trading system, for example, there should be arrangements for prompt transmission to clearing and oversight of settlement pricing.

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