5. Impact of the financial crisis on the security regulatory regime

The recent global financial turmoil has provoked international discussions among the Group of Twenty countries (G20) and within the Financial Stability Board (FSB) on how to set the future direction of financial regulation and supervision, and realize improved international cooperation. The outcome of these discussions will have considerable impact across national borders on the manner in which governments regulate their domestic financial markets.

Financial markets in most Asian countries are still strictly regulated compared to those in advanced economies. There is ample room for liberalization and deregulation to further develop Asian bond markets. Therefore, Asian regulators should work together to identify those areas in which regulation or deregulation is most needed, rather than attempt a series of ad hoc or unilateral responses to the current financial turmoil. Cooperation and information-sharing among regulators and self-regulatory organizations (SROs), such as industry associations and exchanges, and strong political commitment can facilitate development of an effective regulatory framework for Asia to protect investors and prevent systemic risk in cross-border transactions.

This section will focus briefly on the discussions of financial regulatory regimes, including self-regulation in EU, UK and US. The impact of the financial crisis on basic principles of securities regulations will be examined, including the relationship between regulators and market players, concepts of self-regulation, and a possible shift in the regulatory focus of regional authorities. The study will also review models for securities dealers associations in the region to work with each other in promoting cross-border transactions and harmonizing bond standards.

5.1. What went wrong and what are the lessons to be learned?

Global macro-economic imbalances (e.g., the trade imbalance between Asia and the United States [US]) are usually identified as one of the major causes of the global financial crisis. However, the trade imbalance was not the origin of the crisis. Inappropriate risk management in the form of unwise investments in complicated financial products without an exact understanding of these products was the fundamental cause. In response to the crisis, various regulatory measures have been discussed, including capital requirements, liquidity ratios, restraints on bonuses in the banking industry, and leverage ratios, among others. For example, Spain's successful experience in forcing banks to accumulate additional reserves during boom times may seem attractive to regulators. However, the question remains of how much will be enough to stave off another crisis in the future. It is also not clear what level of liquidity is ideal. Capping the leverage ratio may not be appropriate as this does not account for differences in the credit quality of assets and may just push banking activities off of balance sheets. Meanwhile, while bonuses in the banking sector may be excessive, the fundamental problem is whether management fully understands investment risks or at least recognizes that they do not fully understand such risks. In short, there is a wide chasm between reality and the ideal when it comes to reform in the wake of the global financial crisis.

The financial crisis revealed serious deficiencies in financial regulations. In particular, the United Kingdoms' (UK) Financial Services Authority (FSA) must be forced to review the concept of "principle-based regulation." While the FSA might argue that the so-called "light-touch regulation" facilitated market innovation, it also created excessive and extreme financial transactions. It is inevitable that in the future financial supervision will be more intrusive and rules-based. In addition, outcome, and not just interpretation, will be more seriously checked based on regulatory principles. Under the principle-based approach, the right to interpret these principles was given equally to the public and private sectors, which led to a looser interpretation. It is expected that some degree of freedom to interpret regulation will be restrained.

In reaction to the financial crisis, interesting new proposals have emerged. For example, one proposal would restrict the financial industry from committing financial transactions that are not socially useful. Subprime mortgage securitizations increased opportunities for low-income wage earners to buy houses. They thus could be considered socially beneficial in principle. At a certain stage, however, they became useless in terms of social usefulness because the securitization led overinvestment. The question is how and where a line can be drawn. Another interesting question is whether the intellectual property rights of a new financial product should be recognized. The securitization of subprime loans appeared sound when first introduced, but as the competition increased and similar products were sold by competitors the quality of the underlying assets deteriorated. If the intellectual property rights of this new financial product had been recognized and protected, competitive pressures might have been eased and the deterioration in asset quality could possibly have been managed more properly.

5.1.1. Europe[37]

1) New European financial supervision system and the role of ESMA

Based on the report of the de Larosiere Group,[38] the European Commission has proposed transforming the current Level 3 committees[39] which were advisory bodies to the Commission into three European Supervisory Authorities: a European Banking Authority (EBA), a European Insurance and Occupational Pensions Authority (EIOPA), and a European Securities Markets Authority (ESMA). Each new advisory body will have a distinct legal identity. Specifically, the Committee of European Securities Regulators (CESR) will be transformed to into a European Securities Market Authority (ESMA). The group's report concluded that while supervision in Europe is still uneven and often uncoordinated, financial markets are integrated and financial institutions operate across borders. The report recognized the need for convergence among the member states on technical rules and a mechanism for ensuring agreement and coordination among national supervisors of similar cross-border institutions, perhaps through a college of supervisors. The report also proposed coordinated decision making in emergency situations and a rapid and effective mechanism to ensure the consistent application of rules. The current financial services advisory committees were found to be ill-equipped to carry out these functions.

Financial services committees at the European Union (EU) level have advisory powers and can issue non-binding guidelines and recommendations. National supervisors of cross-border groups must co-operate within colleges of supervisors. If they cannot agree, there is no mechanism to resolve the issue. Many technical rules are determined at the member state level, with considerable variation among member states. Even where rules are

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37 European Union Committee (2009), *The Future of EU Financial Regulation and Supervision*

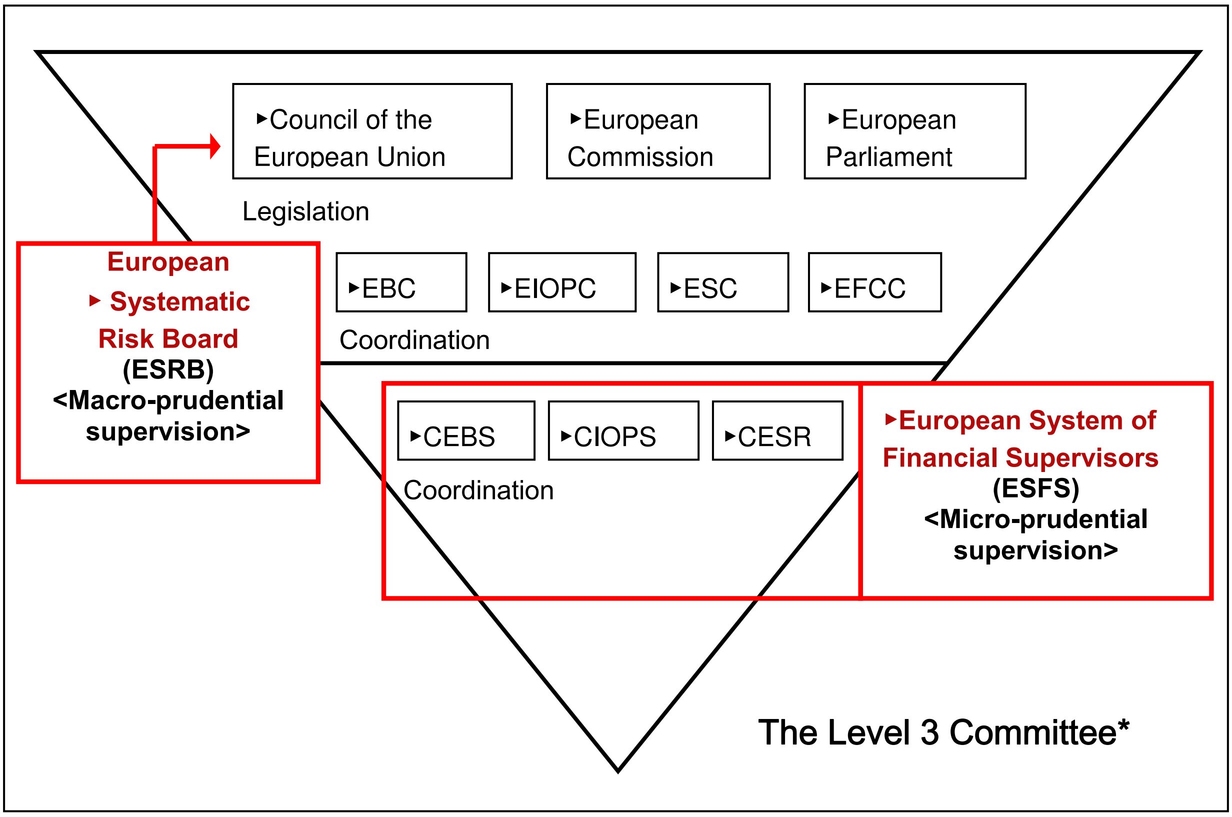
38 In October 2008, the European Commission mandated a high-level group chaired by Jacques de Larosière to give advice on the future of European financial regulation and supervision. The group presented its report on 25 February 2009 and its recommendations were endorsed by the European Commission in its Communication to the Spring European Council of March 2009.

39 Committee of European Banking Supervisors (CEBS), Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS), and the Committee of European Securities Regulators (CESR).

harmonized, their application can be inconsistent. The fragmented supervision undermines the single market, imposes extra costs on financial institutions, and increases the likelihood of failure of financial institutions with the potential for additional costs for taxpayers.

The new European Supervisory Authorities will have much strengthened powers to intervene and enforce a decision. The current financial services committees have coordinated communication among the members, but their roles will become much clearer under the new authorities. In addition, the new authorities will compile a common rulebook by developing technical standards and drawing up interpretative guidelines to assist national authorities in making individual decisions. CESR is currently elaborating the list of technical areas in which the new Authorities need to play a stronger role. It will be critically important to strike a balance between the authorities and national supervisors in financial supervisory policies. ESMA will also exercise direct supervisory authority over credit rating agencies and possibly derivatives markets as well.

Figure 5-21: Financial Regulatory Framework in Europe



Source: summarized from various sources.
EBC = European Banking Committee, EFCC = European Financial Conglomerates Committee, EIOPC = European Insurance & Occupational Pensions Committee, ESC = European Securities Committee

2) Regulatory gaps and cross-sectoral financial supervision

The Level 3 Committees have had regular joint meetings since before the US subprime crisis to cope with problems arising in gray areas even. After the crisis, a cross-sector risk group was created as a joint committee to review inter-sectoral propagation of risks (contagion) and the unintended effect of supervision on other sectors. It was tasked with identifying areas that are not covered by the existing supervision yet are still vulnerable to the proliferation of risk. Through this exercise, it was recognized that regulators should pay more attention to the impact and influence of their actions on other sectors. To achieve this, the mindset of regulators needs to be changed to be more cross-sectoral. As for the retail versus wholesale markets, Europe has not observed clear market failure in wholesale markets. As for sophisticated retail financial products, the European Commission will continue to strengthen transparency and disclosure requirements in line with two consultative papers on transparency that it issued in 2007 and 2009.

3) Market harmonization and integration

In Europe, regulations are still promulgated at the national level and licensing is based on mutual recognition among national regulators. In addition, the resolution of financial institutions must be dealt with nationally. The challenge for supervisors is in coping with financial activities that are increasingly taking place across borders, while their authority and tools are still designed towards the national level. Ring fencing may partially protect domestic markets, but it does not provide an answer for cross-border banking activities.

The new ESMA will work for a common rulebook for security markets, but the task will not be easy. This is because interpretation of regulations and laws may be closely related to national values, tradition, or personal life styles, which all EU member states agree to observe as an important part of their respective heritage. For example, operating hours for retail shops may be tied to religious practices; a preference for equities over bonds, or deposits over bonds, may be related to domestic risk perceptions and preferences. In the UK, individual investors tend to invest in equities but they seldom invest in bonds, while in continental Europe individual investors invest in bonds. Therefore, the necessary framework for investor protection may be different from one country to another. Also, in Germany, regulations must be clearly written, otherwise the regulators cannot prohibit or control financial activities. In such a diverse environment, it is very difficult to introduce the concept of principle-based regulation.

In spite of the difficulties mentioned above, there is optimism among the European Commission and CESR staff. While their goals cannot be achieved immediately, they believe they can reach meaningful agreements in a stepwise manner. This optimism seems to be backed by the confidence established through discussions at various levels within the EU, which was also a necessary component of the effort to create a single currency and manage a common response to the recent financial crisis.

The European Commission has adopted new legislative proposals to strengthen the supervision of the financial sector in Europe. According to the proposals, two new institutions will be created: a European Systemic Risk Board (ESRB) for macro-prudential supervision and a European System of Financial Supervisors (ESFS) for micro-prudential supervision.

Function of the ESRB[40]

The ESRB will monitor and assess risks to the stability of the EU financial system as a whole, provide early warning of systemic risks, and issue recommendations for remedial actions. This can cover a range of areas: from the financial health of banks to the potential

[40] European Commission. 2009. *New financial supervision architecture: Q&A on the European Systemic Risk Board/The macro-supervision part of the package.*

existence of asset bubbles and the smooth functioning of market infrastructure. The ESRB will have to identify all potential risks and prioritize them before issuing warnings when it believes the risks are significant.

The main decision-making body of the ESRB, the General Board, will comprise governors of all 27 national central banks, the President and Vice President of the European Central Bank, the chairpersons of the three newly established European Supervisory Authorities, and a member of the European Commission. Representatives of each national supervisory authority and the Chairperson of the Economic and Financial Committee will participate as observers.

If the ESRB identifies risks to financial stability it shall issue recommendations to the country or group of countries concerned. If the addressee agrees with ESRB's recommendation, it must communicate the actions that it will undertake to deal with the potential problem. If it does not agree with the recommendation and chooses not to act, the reasons must be properly explained. If the ESRB feels that the explanations are not convincing, it shall inform the EU's Council of Ministers.

Generally, all ESRB recommendations will also be sent to the Council of Ministers. In some cases, the council would be the primary addressee if the warnings or recommendations were issued to the European Union as a whole. But in most cases, the warnings and recommendations will be transmitted to the relevant addressee and to the council. This transmission of warnings and recommendations aims at increasing the moral pressure on the recipient either to take action or justify its inaction. It is expected that ESRB warnings will provide significant incentive for authorities to follow-up on its recommendations or give convincing reasons for not doing so.

To ensure smooth discussion, a steering committee—comprising the ESRB chairperson and vice-chairperson, five central bank officials from ESRB members, chairpersons of the new European Supervisory Authorities, the President of the Economic and Financial Committee (EFC), and the European Commission member—will prepare and organize efficient ESRB operations. In addition to the secretariat, an advisory technical committee under the ESRB can be established, if necessary, to discuss specific issues such as insurance.

Function of the ESFS[41]

The European System of Financial Supervisors (ESFS) will become an operational European network of national financial supervisory authorities, with shared and mutually reinforcing responsibilities, working in tandem with newly established European Supervisory Authorities. These new authorities will (i) develop draft proposals for technical standards to help ensure more consistent rules within the EU that work towards a common rulebook; (ii) facilitate the exchange of information and agreements between national supervisory authorities, and where necessary, settle any disagreements, including within colleges of supervisors, for a more coordinated approach; (iii) contribute to ensuring consistent application of European Community rules; and (iv) coordinate decision-making in emergency situations. While the new European Supervisory Authorities will prepare common rules and technical standards as binding measures, day-to-day operations will remain in the hands of national supervisors. The ESMA will exercise direct supervisory powers over credit rating

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[41] European Commission. 2009. *European System of Financial Supervisors (ESFS): Frequently Asked Questions.*

agencies.

The ESFS will be evaluated after 3 years. While it is not possible to pre-judge the outcome of the evaluation, it will provide an opportunity to take stock of how well th e ESFS is performing and whether additional steps need to be taken.

5.1.2. United Kingdom (UK)

It is inevitable that revisions to the European Directives would affect businesses in London. However, such changes would not undermine the competitiveness of the City of London. The competitive advantage of London's markets are not in light regulation, but rather in its vast financial infrastructure, including an intellectual base of legal and accounting experts who can facilitate a range of financial contracts and complex deals.

The gap between the common law tradition in the UK and civil law tradition in continental Europe is still wide, but it is possible to mitigate the effects of this gap. The interpretation and application of regulations are based on the long-lasting legal and social traditions of each individual country. In the UK, market participants may feel they can do whatever is not forbidden, which is in line with a philosophical belief that people should be free from arbitrary interference from the state. On the other hand, in France, more robust involvement by the state into the market is often justified. It will not be easy to close this gap. Cultural differences become even more apparent with respect to consumer and investor protection. But the Europeans have expressed confidence that it will be possible to narrow the gap in the coming years. The accumulation of discussions within the EU seems to be establishing a common understanding. One approach is to reduce a politically sensitive issue to a technical difference, which can be solved through compromise in a professional manner.

The financial crisis demonstrated that the level of information asymmetry between the originators of securitized products and their investors was significant. As a result, it is clear that information related to risks involved in financial products must be disclosed and investors must understand the risks properly. However, the independent Financial Ombudsman Service (FOS) suggests that this may not be sufficient; the notion that more information is always better for investors might need to be reconsidered. Since its establishment, the FOS has received an increasing number of queries and complaints from consumers feeling overwhelmed by the information being provided to them. Although it is still an open question as to what extent financial products are similar to airplanes or automobiles, the financial industry might still need to reconsider its current approach. As long as consumers are dissatisfied, the industry will continue to be asked to improve its provision of information. However, this can lead to a vicious cycle: the more information that is provided on financial products, the more consumers might come to recognize their complexity without completely understanding them, which might only further fuel anxiety.

The new Conservative–Liberal coalition government and the Banking Act of 2009 granted the Bank of England (BOE) a new statutory objective for financial stability by establishing a Financial Stability Committee (FSC). In addition, greater supervisory authority was given to BOE to intervene in troubled and recklessly-behaving banks. The new UK government believes that the existing tripartite regulatory system[42]—detailed in **Figure 5-22** and comprising the BOE, FSA, and Treasury—failed to consider macro-prudential

[42] This system was set up by the previous Labour government and divided financial oversight between the BOE, Treasury, and FSA.

regulations appropriately and therefore was unable to identify and mitigate the global imbalances and excessive borrowing that resulted in global financial turmoil. The UK government believes that the BOE is rightly placed for such a role given its macroeconomic expertise and market knowledge. The government has also given the BOE responsibility for financial stability oversight through the creation of the FSC with new tools to head off threats such as asset price bubbles. Meanwhile, the FSA will be overhauled and reconstituted as three separate authorities: (i) the Prudential Regulation Authority (PRA) for micro-supervision, (ii) the Consumer Protection and Market Authority (CPMA) for consumer protection, and (iii) the Economic Crime Agency (ECA) for prosecution of criminal offenses.

- **Financial Policy Committee (FPC)**

The BOE has two statutory objectives: (i) price stability through the interest-setting function of the Monetary Policy Committee (MPC), and (ii) financial stability through the activities of the FPC. The FPC will have 11 members, with the central bank governor as chairman. Other members will include (i) the BOE's existing deputy governors for monetary policy and financial stability, and its executive directors for markets and financial stability; the (ii) chief executive of the planned CPMA, and (iii) four external members and a non-voting representative from the Treasury. The Governor and Deputy Governors for financial stability and monetary policy will sit on both committees. The FPC will broadly monitor the UK's financial stability and take action necessary in response to systemic risks and vulnerabilities, and report on actions by publishing a bi-annual financial stability report.

- **Prudential Regulation Authority (PRA)**

The PRA will conduct day-to-day supervision of financial firms—banks, building societies and credit unions, investment banks, and insurers—and implement the macro-prudential policies adopted by the FPC. The PRA will be given new powers to supervise and enforce its policies and rules. The PRA will also assess the safety and soundness of financial firms, make the governing rules for the regulated activities of financial firms, approve those individuals required to perform controlled functions within firms, and raise levies to fund the PRA's activities. The PRA will be established as a subsidiary of the BOE, with its own board chaired by the Governor of the BOE. There will be a high degree of integration between the PRA's most senior management and that of BOE and the CPMA.

- **Consumer Protection and Market Authority (CPMA)**

The CPMA will take on the FSA's responsibility for consumer protection. The CPMA will have the regulatory function of setting rules that govern the conduct of financial firms in both the retail and wholesale areas. It will also have the power to grant permission for all regulated activities classified as non-prudential. It is envisioned that the CPMA will coordinate and cooperate with the FPC and the PRA in implementing its powers and functions. The CPMA will be governed by a board with majority of nonexecutives appointed by the Treasury and the Government's Department for Business Innovation and Skills. There will be an executive committee of the board, in which the CPMA's non-executive directors will be expected to participate in circumstances where they are not conflicted, that will have responsibility for supervisor and regulatory decisions.

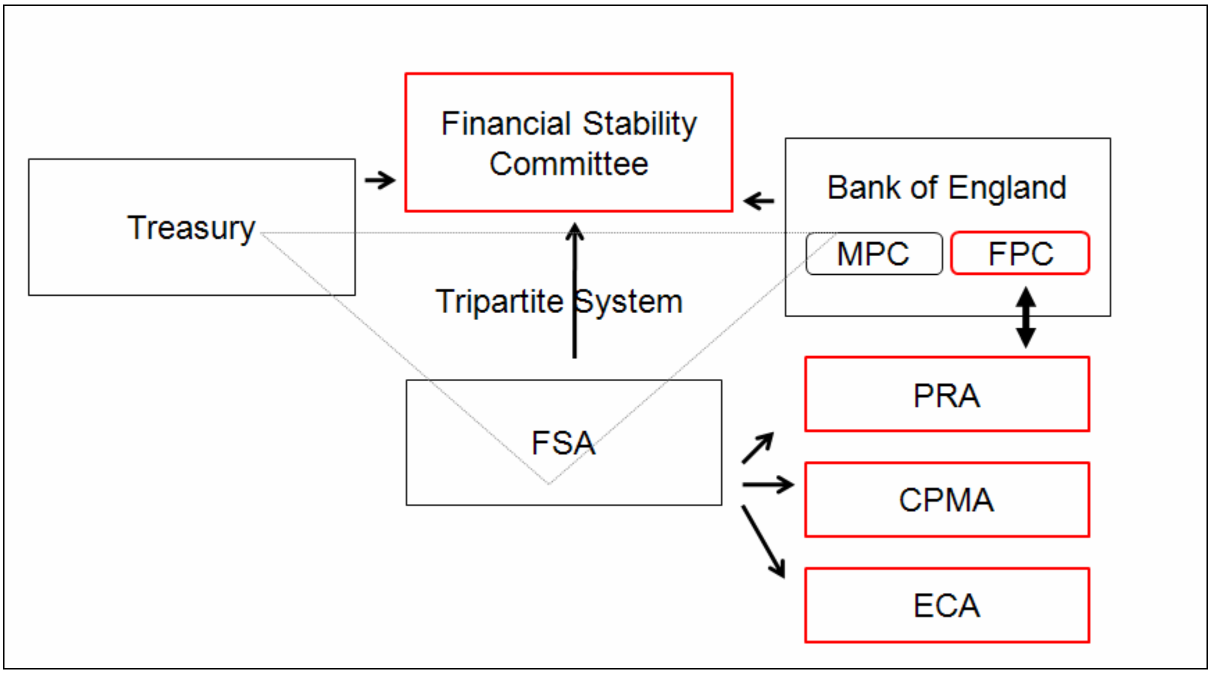
- **Economic Crime Agency (ECA)**

In his Mansion House speech,[43] the Chancellor of the Exchequer announced the establishment of a single new ECA that would assume responsibility for prosecuting criminal

[43] Speech at the Lord Mayor's Dinner for Bankers and Merchants of the City of London by the Chancellor of the Exchequer, the Rt. Hon. George Osborne MP, at Mansion House. http://www.hm-treasury.gov.uk/press_12_10.htm

offences, including those involving insider trading and market abuse, which is currently the responsibility of the FSA and other agencies. However, possible concerns arise related to the overlap of the various proposed enforcement functions. Financial firms could potentially face competing enforcement actions from the PRA for breaches of prudential principles, from the CPMA for breaches of specific rules on market conduct, and from the ECA for breaches of criminal law.

Figure 5-22: Financial Regulatory Framework in the United Kingdom



CPMA = Consumer Protection and Markets Authority, ECA = Economic Crime Agency, FPC = Financial Policy Committee, MPC = Monetary Policy Committee, and PRA = Prudential Regulation Authority.
Source: Summarized from various sources

5.1.3. United States (US)

As a logical response to the financial crisis, the passage of the Dodd–Frank Wall Street Reform and Consumer Protection Act represents the most ambitious and extensive regulatory reform of US laws governing the financial industry and markets since the Great Depression. The bill touches every domestic financial entity and affects most foreign financial entities. While much attention in the bill has been paid to systemically important financial institutions, smaller institutions are affected by many of the regulatory changes as well. As many of the bill's provisions give only a basic structure of reform and leave the regulators to fill in the details over the next 6–18 months, the process of implementing the bill's provisions promises to be a dynamic one. Consequently, the final shape and practical impact of the bill are still years from being understood. The major characteristics of the bill are summarized in **Table 5-36**.

Table 5-36: The Dodd–Frank Wall Street Reform and Consumer Protection Act

Provisions	Brief Summary
Banks	• Preserves the Federal Reserve (Fed) and Federal Deposit Insurance Corporation's (FDIC) bank supervision roles; calls for the Office of Thrift Supervision to be absorbed by the Office of the Comptroller of the Currency • Federal Reserve Board keeps oversight of largest bank holding companies • State banks and holding companies would either be regulated by the Fed or FDIC • Banks generally barred from using their own capital to engage in speculative trades
Consumers	• The Consumer Financial Protection Bureau (CFPB) to be established as an independent entity housed within the Fed; the CFPB will be led by a director appointed by the President and confirmed by the Senate • The CFPB is granted authority to write consumer protection rules for banks and nonbank financial firms offering consumers financial services or products, and to ensure that consumers are protected from "unfair, deceptive, or abusive" acts or practices
Credit Rating Agencies	• Creates an Office of Credit Ratings at the Securities and Exchange Commission (SEC) to administer credit rating agencies' rules and practices, and the authority to fine agencies
Derivatives	• Requires that many derivatives and over-the-counter financial products be traded on regulated platforms, and that trades are cleared through a central clearinghouse
Financial Stability	• Creates a Financial Stability Oversight Council (FSOC) with authority over bank holding companies with assets of more than US$50 billion and nonbank financial companies that the FSOC deems a systemic risk to financial stability
Hedge Funds	• Requires investment advisers of hedge funds with assets of more than US$100 million to register with the SEC
"Volcker Rule"	• Adopts a modified version of the Volcker Rule ban on proprietary trading by banks to generally prohibits banks from engaging in proprietary trading or holding or obtaining an interest in a hedge fund or a private equity fund • Banks are permitted to invest up to 3.0% of their Tier 1 capital in hedge funds and private equity funds, but a bank's interest may not exceed 3.0% of the assets of any single hedge or private equity fund; banks are permitted to invest in entities backed by the federal government such as federal, state, and local debt, as well as obligations of Ginnie Mae, Fannie Mae, Freddie Mac, and other government entities; banks are also permitted to engage in hedging activities

Source: summarized from various sources.

Throughout the Dodd–Frank's legislative process, various proposals were considered to streamline the US financial regulatory regime. Ultimately, the bill abolished the Office of Thrift Supervision (OTS), the current federal supervisor for thrifts and thrift holding companies, and reallocated OTS' authorities to the Office of the Comptroller of the Currency (OCC) for thrifts and to the Federal Reserve Board (FRB) for savings and loan holding companies. The bill also strengthens the enforcement of oversight powers of the Securities and Exchange Commission (SEC) in many aspects. It provides the SEC's Division of Enforcement with a host of new legal instruments. Among the most significant are new incentives and protections for whistleblowers, new authority to charge aiding and abetting violations, and penalties in administrative proceedings.

- **Financial Stability Oversight Council (FSOC)**

The FSOC will be created with authority over bank holding companies with assets of more than US$50 billion and nonbank financial companies that the FSOC deems a systemic risk to financial stability. Once designated systemically important, nonbank financial companies have 180 days to register with the Federal Reserve (Fed). FSOC will comprise nine voting members led by the Treasury Secretary. The other voting members will include the heads of the SEC, OCC, Federal Reserve Board of Governors, Consumer Financial Protection Bureau (CFPB), Federal Deposit Insurance Corporation (FDIC), Federal Housing Finance Administration (FHFA), and National Credit Union Administration (NCUA); as well as an independent insurance expert appointed by the President for a 6-year term. There are also five non-voting members, including the directors of the Office of Financial Research and the Federal Insurance Office, a state insurance commissioner, a state banking supervisor, and a state securities commissioner.

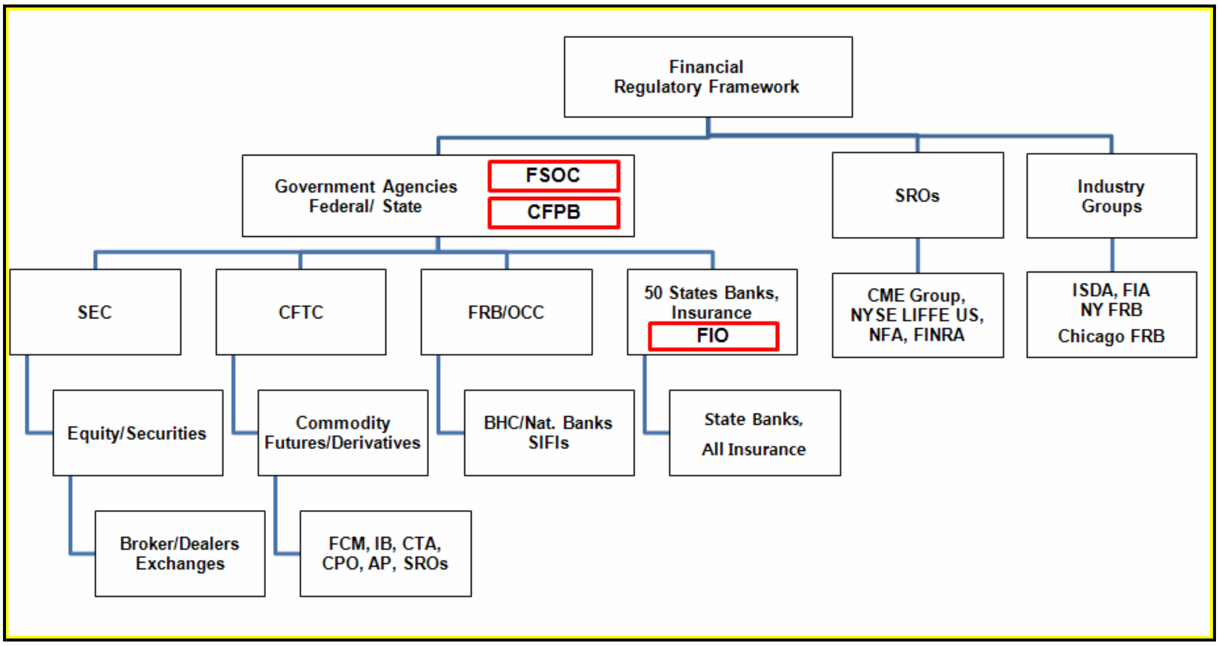
- **Consumer Financial Protection Bureau (CFPB)**

The CFPB will be housed within the Fed and established as an independent authority to write consumer protection rules for banks and nonbank financial firms offering consumers either financial services or products, and to ensure that consumers are protected from "unfair, deceptive, or abusive" acts or practices. The CFPB will also have the authority to examine and enforce regulations for banks and credit unions with assets of more than US$10 billion, all mortgage-related business, and large nonbank financial businesses.

- **Federal Insurance Office (FIO)**

The bill establishes an FIO to be housed within the Treasury Department. The FIO will be responsible for monitoring all aspects of insurance companies and identifying issues or gaps in regulation that could lead to systemic risk. Based upon its findings, the FIO will make recommendations to the FSOC regarding insurance companies that pose systemic risk and should be subject to greater regulatory oversight. The FIO will coordinate federal endeavors to regulate the insurance industry. Finally, the FIO will develop federal policy on prudential aspects of international insurance matters.

Figure 5-23: Financial Regulatory Framework in the United States



BHC = bank holding company, CFPB = Consumer Financial Protection Bureau, CFTC = Commodity Futures Trading Commission, CME = Chicago Mercantile Exchange, CTA = Commodity Trading Advisor, FCM = futures commission merchant, FIA = Futures Industry Association, FINRA = Financial Industry Regulatory Authority, FIO = Federal Insurance Office, FSOC = Financial Stability Oversight Council, ISDA = International Swaps and Derivatives Association, NFA = National Futures Association, OCC = Office of Comptroller of the Currency, SEC = Securities and Exchange Commission, SIFIs = systemically important financial institutions.
Source: CFTC and various sources.

5.2 The role of self-regulatory organizations (SROs) and securities dealers associations

5.2.1. Lessons from European experiences (ICMA)

SROs, in general, are defined as private non-governmental entities that are delegated authoritative power by government regulators in the context of International Organization of Securities Commissions (IOSCO) Principles. SROs are dedicated to the public interest objective of enhancing market integrity and efficiency, and investor protection. They can establish rules and codes to ensure regulatory objectives. While SROs do not have authoritative power to impose sanctions for breach of rules and codes, peer pressure and mutual trust among market participants warrants their enforceability.

The International Capital Market Association (ICMA[44]) acts as an SRO in the Eurobond market and facilitates interactions between issuers, lead managers, dealers, and investors in support of an efficient and well-functioning security market. Since the recent financial turmoil erupted, ICMA has also committed to rebuilding orderly capital markets and working closely with governments, central banks, regulators, and the constituencies they serve to achieve a fair balance between the interests of market participants and regulatory authorities.

5.2.1.1. Effectiveness of the European model: importance of SROs in rules-setting

The roles and objectives of ICMA are as follows: (i) set standards of good practice for orderly markets in consultation with members so that membership in ICMA is seen as a seal of approval by peers, regulators, and supervisors; (ii) consult members and represents their views with regulators and central bankers on cross-border regulatory issues in Europe; (iii) represent both sell-side and buy-side members while facilitating dialogue between them; (iv) work in cooperation with other trade association where it makes sense for members to do so; and (v) share experiences of setting standards of good market practice in Europe with other trade associations and SROs in the rest of the world.

SROs are deemed effective because they can flexibly adjust their rules and codes to meet changes in market practices, and they can closely communicate with member institutions to make effective rules.

5.2.1.2. To what extent is the European model is still valid?

In Europe, the role of SROs is not a focus of the current discussion of regulatory changes. As Euromarkets are offshore, they are not subject to any specific national jurisdiction. ICMA's position to set rules for Euromarkets has not been questioned. However, definition of the professional market participants might be reviewed and tightened restrictions

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44 ICMA (2008),"The Role of Self-Regulation", ICMA Regulatory Policy Newsletter.

on sales of financial products may affect the ICMA's rules and codes of conduct. Within the European Commission, there is not much active discussion on SROs. The role of SROs and their effectiveness may be different from one market to another, particularly in the US where the relevant SRO did not function as expected since it failed to identify serious fraud. The rules in place in the US were not effective enough to control transactions because the SRO is closely related to legal tradition and its relationship with regulators. Therefore, Asia should define a self-regulatory regime that is most suitable to Asian countries.

5.3 How does the ASEAN+3 region construct and revise its regulatory regime?

5.3.1. Does the current security regulatory regime need to be changed?

When compared to the US and Europe, Asian bond markets showed a relatively better performance in the current financial crisis. The crisis revealed that the existing global standard is not a panacea. However, the crisis has not shown that Asia's current regulatory regime is perfect either. There is no reason for complacency. In response to the financial crisis, it is inevitable that financial regulation and supervision will be strengthened. Ongoing discussions and proposals in the G20 and FSB will have a substantial impact on the future direction of regulatory changes and financial market development in Asia. However, there is still room for market liberalization and deregulation in most Asian countries to further develop a regional bond market as well as domestic bond markets. Therefore, Asian economies need to design their own financial architecture and regulatory regimes in line with global best practices and current discussions in the G20 and FSB, rather than tighten financial regulations on an individual or ad hoc basis.

The recent global financial crisis has re-emphasized the need for strengthening regional financial cooperation among Asian countries. Indeed, regional financial cooperation has accelerated in the wake of the crisis. Specifically, Asian governments need to make a more concerted effort to develop an international common bond market for Asian currencies, which is currently almost non-existent, in order to better utilize the high level of Asian savings. Given the diversity of socio-economic conditions and financial developments, and increasingly inter-connected financial markets in the region, Asia needs to consider a consistent regulatory approach that is applicable to a regional common international bond market to efficiently facilitate cross-border transactions and financial integration.

5.3.2. How can cooperation among securities dealers associations in the region be enhanced with a view to harmonize bond standards at the market-level in the long run?

Table 5-37 indicates that there are notable discrepancies among countries in the region with respect to their complicated and overlapping structures of securities regulation. For example, the PRC's bond markets are segmented based on the issuer and various securities laws. In addition, each segmented market is subject to different regulators and the regulatory regime is overlapping and fragmented without clear definitions of regulatory responsibilities.

Table 5-37: Securities Regulations in Selected Countries

	Main Securities Supervisor	Other Relevant Securities Authorities	SRO[45] (Exchange, Industry Association)	Structure of Financial Supervision
China	CSRC	NDRC, CBRC, PBOC	NAFMII	Multiple
Indonesia	BAPEPAM	Bank Indonesia	BEI,	Multiple
Japan	FSA		TSE, JSDA	Single
Korea	FSC	FSS	KRX, KOFIA	Single
Malaysia	SC	BNM	BMB, MIBA, ACI-Malaysia	Semi
Singapore	MAS		SGX	Single
Thailand	SEC	BOT	TBMA	Multiple

ACI-Malaysia = Securities Dealer's Association), BAPEPAM = Badan Pangawas Pasar Modal (Capital Market and Financial Institution Supervisory Agency), BEI = Bursa Efek Indonesia (Indonesia Stock Exchange), BMB = Bursa Malaysia Berhad, BNM = Bank Negara Malaysia, CBRC = China Banking Regulatory Commission, FSA = Financial Services Agency, FSC = Financial Services Commission, FSS = Financial Supervisory Service, JSDA = Japan Securities Dealer's Association, KOFIA = Korea Financial Investment Association, KRX = Korea Exchange, MIBA = Malaysian Investment Banking Association (Primary Market Association for Bonds), NAFMII = National Association of Financial Market Institutional Investors, PBOC = People's Bank of China, SC = Securities Commission, TSE = Tokyo Stock Exchange, NCSRC = China Securities Regulatory Commission, NDRC = National Development and Reform Commission.

Source: Eschweiler, Bernhard (2006), "Bond market regulation and supervision in Asia", *Asian bond markets: issues and prospects*, BIS, vol. 30, pp 335-352.and various sources

Developing domestic bond markets has been a major policy concern since the 1997/98 Asian financial crisis. Given current circumstances, developing a common cross-border market to further promote regional integration should be made a top priority. A regional framework for securities regulation to effectively create cross-border markets is also needed. However, cross-border transactions in Asia are very limited due to strict capital flow controls, currency restrictions, and foreign exchange (FX) controls. Some countries follow a quota system while others have exchange controls in which FX transactions must be substantiated by actual transactions. However, as regulations move towards liberalization and regional investors expand, cross-border transactions will increase, which increases the need for an effective and consistent regulation framework for cross-border transactions. One of the lessons from the sub-prime mortgage crisis is that while there were too many regulators and supervisors in the UK and US, there were not enough cross-border regulatory agencies.

5.3.3. The roles and merits of Asian SROs or securities dealers associations.

In general, the majority of SRO members include brokers–dealers, who are also well represented in the governance of SROs. The self-policing arrangement of SROs enforces compliance with common rules of conduct from each member. Industry input into the rules-making process and representation through market consultations contribute to effective compliance procedures. Compared to statutory regulations, SROs have flexibility and can adapt quickly to changing regulatory requirements, an evolving business environment, or new financial innovations. In this respect, self regulation, in general, imposes fewer costs

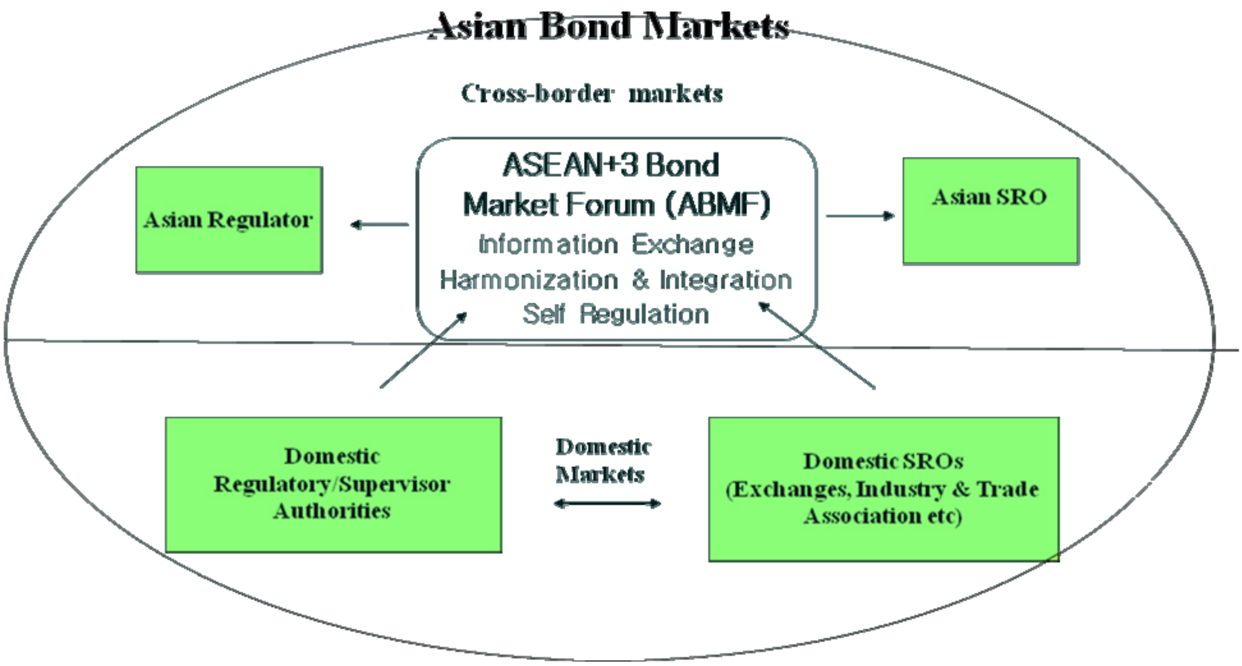
[45] See more details of major SROs in ASEAN+3 in Annex 3.

than government-led statutory regulation.

5.3.4. Asian model of SROs: Relationship with regulators and domestic SROs

In Asia, supervisory authorities are often not independent from the government or related authorities, such as the central bank, in the performance of their roles and functions. In many cases, the government interferes with the supervisory authorities in the enforcement of laws and regulations. In addition, most SROs in the region are led by public regulators and the government, and consequently they play a limited role in securities regulation. In most countries the use of SROs is limited to public exchanges instead of as a genuine securities industry association.

Figure 5-24: Regional Framework for Asian Bond Markets



There are two approaches to rules-setting and SROs in cross-border transactions in **Figure 5-24**. First, a forum for regulators should be established to identify effective regulations that are consistent across jurisdictions. Second, a regional forum should be convened for market participants to set regional self-governing rules for offshore transactions that are not subject to any one country's regulation. This forum could eventually evolve into an Asian Supervisory Authorities, or an Asian SRO, if such bodies were deemed suitable for the region. In Asia, where there is no central political body like the European Commission, the ABMF could bring together regional regulators and supervisors, as well as market participants, at the regional level to cooperate and exchange information with the aim of harmonizing differences in regulatory frameworks.