



OECD Working Papers on Public Governance No. 16

**Tools for Regulatory Quality  
and Financial Sector  
Regulation: A Cross-  
Country Perspective**

**Julia Black,  
Stephane Jacobzone**

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## **TOOLS FOR REGULATORY QUALITY AND FINANCIAL SECTOR REGULATION: A CROSS-COUNTRY PERSPECTIVE**

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## ABSTRACT

### **Tools for regulatory quality and financial sector regulation: A cross-country perspective**

This report provides a comparative perspective on the application of quality regulation principles to financial sector regulators, in the US, Canada, Australia, the UK and France. The report compares key provisions of the codes of the Basle Committee and IOSCO, with the OECD's 2005 *Guiding Principles for Regulatory Quality and Performance*, and the 2009 *Policy Framework for Effective and Efficient Financial Regulation (PFEEFR)*. The report analyses the independence and accountability of the regulators, as well as their powers. The analysis focuses on requirements for *ex ante* and *ex post* regulatory impact analyses, including burden reduction; for transparency and communication of decision making, as well as co-ordination and regulatory review; for improving the regulatory system over time and for regulating conflicts of interest. The report finds variation in the formal arrangements, and respective practices. It also finds that the requirements related to better regulation principles are often implemented too late in the decision-making process when regulations are set at the international level.

## TABLE OF CONTENTS

ABBREVIATIONS .....	6
EXECUTIVE SUMMARY .....	7
1. Introduction.....	11
1.1 Aims and structure of the report .....	11
1.2 Sources of General Principles of Quality Regulation.....	11
2. Current trends and challenges .....	12
2.1 Sector specific issues in the organisation of financial services regulation .....	12
2.2 International and EU context of financial regulation and principles of quality regulation.....	13
3. Independence and Accountability .....	19
3.1 Assessing independence .....	19
3.2 Independence of financial regulators.....	21
3.3 Accountability .....	25
4. “Powers for High Quality Regulation” .....	33
4.1 Licensing / authorisation .....	33
4.2 Rulemaking.....	33
4.3 Monitoring and investigation.....	34
4.4 Monitoring – Risk-based approaches .....	34
4.5 Response & Enforcement .....	34
5. Maximising the quality of regulatory power – “better regulation” arrangements .....	38
5.1 Executive “whole-of-government” structures for ensuring regulatory quality.....	39
5.2 Regulatory Quality (i) <i>Ex ante and ex post</i> regulatory impact assessments including burden reduction evaluations.....	46
5.3 Regulatory Quality (ii) Transparency and communication .....	51
5.4 Regulatory Quality (iii) Co-ordination mechanisms .....	53
5.5 Regulatory Quality (iv) A dynamic approach to improving the regulatory system over time ..	58
5.6 Regulatory Quality (v) Ethics codes, conflicts of interest policies and confidentiality provisions .....	60
SUMMARY AND CONCLUSIONS .....	64
ANNEX A. STRUCTURES OF FINANCIAL REGULATION IN AUSTRALIA, CANADA, FRANCE, THE UK AND THE USA .....	66
ANNEX B. BASLE COMMITTEE ON BANKING SUPERVISION, CORE PRINCIPLES FOR BANKING SUPERVISION 2006 .....	78
ANNEX C. IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION 2002 (UPDATED FROM 1997).....	81
ANNEX D. CODES INCLUDED IN THE WORLD BANK & IMF REPORT ON STANDARDS AND CODES REVIEW .....	84

## Tables

Table 1.	Source and application of “quality regulation” principles to financial regulation.....	12
Table 2.	Varieties of Regulatory Structures .....	13
Table 3.	Comparison of formal structures of independence .....	25
Table 4.	Accountability Relationships.....	32
Table 5.	Summary of frameworks and processes for promoting quality regulation.....	63

## Figures

Figure 1.	Basic Structure of Global Financial Regulation .....	15
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## Boxes

Accountability: A Framework for Analysis.....	26
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## ABBREVIATIONS

AMF	Autorité des Marchés Financiers
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
BCBS	Basle Committee on Banking Supervision
BRE	Better Regulation Executive (UK)
CBA	Cost benefit analysis
CFTC	Commodities and Futures Trading Commission (US)
FFIEC	Federal Financial Institutions Examination Council (US)
FR	Federal Reserve
FSA	Financial Services Authority (UK)
FSAP	Financial Sector Assessment Programme
GAO	Government Administrative Office (US)
IMF	International Monetary Fund
IOSCO	International Organisation of Securities Commissioners
MoU	Memorandum of Understanding
NAO	National Audit Office (UK)
OBPR	Office of Best Practice Regulation (Australia)
OCC	Office of the Comptroller of the Currency (US)
OIRA	Office of Information and Regulatory Affairs (US)
OMB	Office of Management and Budget (US)
OSC	Ontario Securities Commission
OSFI	Office of the Superintendent of Financial Institutions (Canada)
PFEEFR	Policy Framework for Effective and Efficient Financial Regulation
RIA	Regulatory Impact Assessment
SEC	Securities and Exchange Commission (US)

## EXECUTIVE SUMMARY

This report is prepared to provide information on the application of principles of quality regulation to regulators in the financial sector. It examines the systems in place to ensure “quality regulation” which apply to ten financial regulators in five countries, the US, Canada, Australia, the UK and France.<sup>1</sup> This report contributes to the OECD's *Strategic Response to the Global Financial and Economic Crisis*.

The OECD has a longstanding concern with quality regulation (OECD, 1995, 2006). It has also tracked the development of independent regulatory agencies across a number of different countries, and engaged in an evaluation of countries' regulatory systems against the principles of quality regulation that it has developed (OECD, 2003, 2004, 2005, 2006). This report follows the analytical framework developed in OECD (2005) and adopts a cross-sectoral regulatory governance perspective, assessing regulatory quality management tools and strategies in relation to financial sector regulation. The aim of the report is largely to set out in formal and descriptive terms some of the main structures and processes for ensuring quality regulation; it is not to evaluate the extent to which regulators produce “quality regulation” or to draw conclusions as to the relevance of those processes to the performance of financial regulators in recent times, particularly leading up to the crisis.

*The first main part of the report* examines the range of principles of good regulation to which financial regulators are subject at the international level, notably the codes of the Basle Committee and IOSCO, and compares their main provisions with the OECD's principles on quality regulation. The OECD has developed two sets of principles that could potentially apply. The first includes the general OECD principles for quality regulation, with the 2005 *Guiding Principles for Regulatory Quality and Performance*, which build on the 1995 *Recommendation on Improving the Quality of Government Regulation*. The second is the Recommendation of the OECD Council on a *Policy Framework for Effective and Efficient Financial Regulation (PFEEFR)* (OECD, 2009), which follows discussions in recent years on the effectiveness and efficiency of financial regulations by the Committee on Financial Markets and the Insurance and Private Pensions Committee. It includes a *General Guidance* and a *High-level OECD Checklist*. The second set refers to good general regulatory approaches, but is more specifically designed to capture the specificities and institutional set-up of the financial sector.

The 2005 OECD *Guiding Principles of Regulatory Quality and Performance* are obviously broader in scope than the sector specific principles. They address “whole-of-government” issues such as extending the regulatory quality to cover public services, the institutional oversight of the regulatory process, impact assessment, transparency and access to information, compliance, and the need to ensure that regulation is compatible with competitive market environments and liberalisation. They also contain specific provisions with respect to competition law and economic regulators which are less directly relevant to financial regulators.

There are also areas of overlap. The 2005 *OECD Guiding Principles of Regulatory Quality and Performance*, and the *IOSCO Principles and the Basle Core Principles* have similar provisions relating to the clarity of legislative and policy goals, for example, and for the need for regulators to be transparent and accountable. The *PFEEFR* also includes such considerations, as does the IMF Code of Good Practices on Transparency in Monetary and Financial Policies.

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1. The research for the report was conducted from January-March 2009.



Nonetheless there are areas of “underlap”. There are items in the 2005 *OECD Guiding Principles of Regulatory Quality and Performance* which could be applied in the sector-specific context. For example, the OECD Principles contain explicit requirements relating to the nature of the regulatory requirements and the provisions for their review and assessment which are also reflected in the *PFEEFR*.

On the other hand, there are elements of the Basle and IOSCO Principles which could apply on a “whole-of-government” basis but are not particularly developed in the 2005 *OECD Guiding Principles of Regulatory Quality and Performance*. In particular, the Basle Principles focus to a far greater extent on risk management issues, which are largely but not entirely absent from the 2005 OECD Guiding Principles. In addition, the BCBS Principles require that “supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups, and also of the banking system as a whole.” Such a provision for the need for a clear grasp of the dynamics of the organisations and system being regulated is not explicitly part of the 2005 *OECD Principles of Regulatory Quality and Performance* but could be an interesting candidate for inclusion, obviously amended to render it of more generic application. This type of provision is a key element of the *PFEEFR*, drawing on the consequences of the global financial crisis, along with the principle of proper transparency of the financial system.

There are also arguably omissions from all three sets of existing principles. Notable by its absence, for example, is a requirement for one of the key regulatory skills which has proved critical in financial regulation: the assessment of risk, and the integration of systemic risk evaluation into the assessments and regulatory requirements for individual financial institutions. Amended to render it of more generic application, such a principle would require, for example, that regulators develop an understanding of the implications of changes in the macro-economic environment for regulated firms and the system as a whole. Further, the principle on “co-ordination” which is included in the 2005 *OECD Guiding Principles of Regulatory Quality and Performance* could be expanded. The 2005 Guiding Principles emphasise co-ordination with competition authorities, or with other areas of policy making. The co-ordination issue which has been critical in financial regulation however, is the co-ordination of regulators within the same policy domains, and with their counterparts in other countries, which arguable is not fully captured by the OECD Principles. However, all of these considerations are included in the recent *PFEEFR* completed in 2009.

The second main part of the report considers the independence of the agencies and their accountability relationships. With respect to independence, although the exact nature of the regulators’ relationships with other organs of government varies in the details, there are some broad similarities. In general the executive appoints the board or equivalent, and can remove appointees, though usually has to show cause. The regulators have a strong degree of operational independence, and two thirds are financially independent of the executive or legislature, with a level of independence that exceeds what is observed in other sectors, such as telecommunication regulation (OECD, 2005). All the regulators examined here are solely responsible for licensing and approving the financial institutions that they regulate with the exception of the Canadian Office of the Superintendent of Financial Institutions (OSFI). Most, though not all, have independent rule-making powers, though the exercise of these powers may be subject to review on cost-benefit grounds by an agency of the executive, or by the legislature. All have a range of administrative powers of intervention and sanction, and their decisions are subject to review by their national courts.

Accountability structures also vary in their specifics, but in general terms, all the regulators within the scope of the report are under obligations to report to the executive and in some cases separate obligations to report to the legislature. Their decisions are subject to review and / or appeal to the courts. All are subject to financial audits and performance assessment by their national audit offices. Accountability to stakeholders is generally assured through formal consultation processes and in the case of the Australian Securities and Investments Commission (ASIC) and the UK Financial Services Authority (FSA), through separately constituted consumer panels.

**The third main section** considers the powers of the regulators for high quality regulation. The greatest variation is with respect to rule making powers, where OSFI and ASIC lack powers to make binding rules, yet in contrast the FSA, the Securities and Exchange Commission (SEC) and the Commodities and Futures Trading Commission (CFTC), for example, have extensive rule making powers exercised independently of the executive. All have powers of investigation and enforcement, though the AMF is unique amongst those regulators examined here in having a separately constituted disciplinary body.

**The fourth main section** draws on the 2005 *OECD Guiding Principles of Regulatory Quality and Performance* and previous country-specific reports to identify five particular areas for attention. In addition to the areas focused on in the country specific reports (OECD, 2003, 2004, 2006), this report also focuses on the issue of integrity, emphasised in the OECD's Principles, by examining the formal arrangements for managing conflicts of interest between the regulatory officials and those they are regulating. This area has been subject to significant work by the Public Governance Committee from the perspective of the public service as a whole, and including a progress report on the implementation of guidelines for *Managing Conflicts of Interest*.<sup>1</sup> However, this work did not include a specific focus on the bodies charged with the oversight of the financial sector. The fourth section of this report thus focuses on the extent to which the financial regulators focused on here are subject to the following requirements:

- *Ex ante* and *ex post* regulatory impact analyses, including “burden reduction” assessments.
- Transparency and communication of decision making.
- Co-ordination mechanisms.
- Dynamic approach to improving the regulatory system over time.
- Regulation of conflicts of interest.

There is considerable variation in the formal arrangements for ensuring quality regulation in these five areas. There is a centralised process of executive scrutiny of *ex ante* regulatory impact assessments (RIAs) in Australia and the US with respect to the Office of the Comptroller of the Currency (OCC). The Federal Reserve is not subject to this review, but has issued rules jointly with the OCC, such as for the implementation of the Basel II capital accord, and incorporated the OCC's RIA in that rule making notice. The CFTC, the OSC and the FSA are subject to specific statutory duties to conduct cost benefit analysis (CBA). The SEC is under a statutory obligation to take a range of considerations into account, but not specifically to perform a RIA or CBA. OSFI is subject to “whole-of-government” expectations and guidance to perform an RIA.

There is a much less systematic process in most countries for regular *ex post* review separate from sunset provisions, although in each country the equivalent of the national audit office or other “whole-of-government” scrutiny body performs assessments of regulatory performance, though these are often sporadic. In addition, financial regulators in the UK, Australia and Canada have been reviewed by the IMF under its Financial System Assessment Programme. The new *PFEEFR* has an explicit requirement for *systematic review*, in terms of regulatory process and enforcement.

With respect to transparency, all the regulators are required to issue formal consultations of proposed rules or guidance, whether by statute or “whole-of-government” guidance or both. All are required to publish annual reports, and all now publish strategic plans even if not required to do so by statute. Many have advisory panels of industry representatives, and the AMF and the FSA also have advisory or consultative panels which represent investors.

Co-ordination mechanisms are clearly at a premium in financial regulation. All the regulators are members of a formal co-ordinating body at the national level. The AMF again is unique here in that there is cross-board membership between the AMF and the prudential regulators, which can enhance co-ordination.

Within the EU, France and the UK are also members of the EU regulatory structures for financial regulation. All are members of the main international co-ordinating bodies. The need to enhance co-ordination, particularly at the international level, is clearly a salient policy issue, and the situation is obviously in a state of flux at present.

With respect to the improvement of regulation over time, only Australia and Canada have a formal set of sunset provisions. Australia has introduced a formal system of periodic reviews through the use of sunset provisions for legislative instruments through the *Legislative Instruments Act 2003*. Moreover, Australia has introduced five yearly reviews for regulation that is not subject to sunset or other statutory review provisions. The first tranche of review will commence in 2012.

Finally, with respect to integrity, all the regulators are subject either to statutory provisions and / or guidance on conflicts of interest, though only the UK does not have specific provisions relating to employment on leaving the regulator (so called “revolving door” provisions).

It appears that requirements related to better regulation principles at the national level are implemented too late in the decision-making process when regulations are set at the international level.

The report concludes with a brief consideration of three questions which this report raises:

- Do the 2005 *OECD Guiding Principles of Regulatory Quality and Performance* cover the relevant aspects of the regulatory functions exhibited by the relevant financial regulators? Where they do not, are these covered by the *PFEEFR*?
- Is the application of practices and principles of quality regulation aligned with the institutional structures of decision making – in other words, do they apply to the critical decision points and key decision makers in the regulatory process?
- Is there a need for co-ordination of the principles of quality regulation to which financial regulators are subject at the international, regional and national levels?

## **1. Introduction**

### ***1.1 Aims and structure of the report***

This report is prepared to provide information on the relevance of principles of quality regulation to regulators in the financial sector. The OECD work on regulatory policy has had a long running concern with quality regulation, recently updating its initial principles on quality regulation issued in 1995 (OECD, 1995, 2006). It has also tracked the development of independent regulatory agencies across a number of different countries, and engaged in an evaluation of countries' regulatory systems against some of the principles of quality regulation that it has developed (OECD, 2003, 2004, 2005, 2006). This report follows a similar line of inquiry, and adopts a cross-sectoral regulatory governance perspective, assessing regulatory quality management tools and strategies in relation to financial sector regulation.

The report examines the application of principles for quality regulation to nine financial regulators in five different countries: Australia, Canada, France, the UK, and the US. It focuses only on securities and banking regulators; it does not extend specifically to the regulation of insurance and pensions / superannuation, except where these functions are performed by the banking and / or securities regulators examined here.

The report looks first at the organisation of financial regulation in these countries, and outlines the various principles of quality regulation that have been developed at the international level, including those of the OECD as well as the global financial regulatory bodies. It then turns to consider the independence and accountability of the agencies, disaggregating the regulatory functions and examining to what extent regulators are independent, in formal terms, in their institutional structures and in the performance of those different functions. In the fourth section, the report considers the powers that the different regulators have to deliver "quality regulation". The final section focuses on five key principles of quality regulation and examines to what extent these are observed, at least in formal terms, by the different financial regulators that are within scope.

### ***1.2 Sources of General Principles of Quality Regulation***

The 2005 *OECD Guiding Principles of Regulatory Quality and Performance* are not the only principles which are potentially applicable to financial regulators. The *Policy Framework for Efficient and Effective Financial Regulation (PFEER)* prepared by the OECD Committee on Financial Markets focuses on the policy framework, operating at a higher level than the internationally accepted standards developed by international standard-setting organisations. It is not meant to substitute for the more focused, micro-prudential guidelines and recommendations of the international standard-setting bodies, but is rather intended to operate at a higher level and address the policy framework as well as financial regulation at a general level. There are international principles as well as regional (EU) and national level, "whole-of-government" principles of better regulation which can apply, in addition to provisions applying just to the regulator itself in its parent legislation. Just as regulation of private actors is multi-layered, quality regulation management is similarly distributed across a wide range of bodies operating at different levels and utilizing different combinations of hard and soft law.

At the international level, the regulatory regime for financial services is notable for the plethora of international bodies who are involved in formulating codes of practice to which countries are meant to conform. These cover issues ranging from general exhortations to highly detailed provisions, such as those contained in the Basle II Capital Accord which provides the basis of capital adequacy regulation for deposit taking institutions. Whilst many of these codes contain technical provisions which are specific to the sector, there are codes which contain principles for what may also be described as "quality regulation" in that they relate to the organisation and performance of financial regulation. Conformance to these

principles is, to an extent, monitored by the World Bank and the IMF through the FSAP process (Financial Sector Assessment Programme), introduced in 1999.<sup>2</sup> Through this process, the IMF and the World Bank assess compliance with twelve codes issued by the IMF and specialist international regulatory bodies, including IOSCO, the BCBS and the IAIS (see Annex D). These include the BCBS *Core Principles for Effective Banking Supervision*, IOSCO’s *Objectives and Principles for Securities Regulation* and the OECD’s *Principles for Corporate Governance*.

At the regional level, the EU has recently been developing a “better regulation” agenda, focusing in particular on impact assessment, burden reduction, simplification and consultation (*e.g.* European Commission, 2009a). The agenda applies both at the level of EU regulation and to regulation within Member States. In addition, significant changes to the structure of regulation of financial supervision at the European level are currently being debated (see further Section 5.4.6).

At the national level, the countries examined here also have “whole-of-government” initiatives and requirements relating to “better regulation” or “quality regulation” which also apply to the financial services regulators.

Finally, some of the regulators are under specific statutory duties to conduct processes which are normally thought of as contributing to quality regulation, such as cost benefit analysis and requirements on consultation and transparency. Moreover some have developed their own “better regulation” agendas.

**Table 1. Source and application of “quality regulation” principles to financial regulation**

Source and application of “quality regulation” principles	Example
Supranational and cross-sectoral	OECD Guiding Principles for Regulatory Quality and Performance;
Supranational and sectoral	Basle Committee Core Principles for Banking Supervision IOSCO Objectives and Principles for Securities Regulation OECD PFEER
Regional and cross-sectoral	EU Better Regulation agenda
Regional and sectoral	EU Green Paper on Financial Services Policy 2005-10
National and cross-sectoral (“whole-of-government”)	Australian Office of Best Practice Regulation; UK Better Regulation Executive; US Office of Management and Budget
National and sectoral	Legislative requirements for quality regulation, <i>e.g.</i> CBA: FSA, CFTC, OSC
Sectoral: self generated	“Better regulation” agendas developed by regulators, <i>e.g.</i> FSA, ASIC

## 2. Current trends and challenges

### 2.1 Sector specific issues in the organisation of financial services regulation

The current financial crisis has clearly thrown into sharp relief the “boundary problem” – what should the boundaries of regulation be, and how best should the institutional structures of regulation be organised in order to minimise the risks of overlap and underlap between the different bodies involved in their regulation. Clearly, this question arises at the international, cross-national and national levels.

Even at the national level, the question of how best to organise financial regulation is the subject of significant policy debate and there is a significant cross-national variation in regulatory regimes (see *e.g.* Davis and Green, 2008). The variations occur along four dimensions:

- Whether the regulatory institutions are organised sectorally or whether there is one integrated regulator.
- Whether the central bank also conducts prudential regulation of banks.
- The distribution of regulatory functions between the federal and provincial or state level in federal systems
- The distribution of regulatory functions between governmental agencies and self regulatory or non-state organisations.

Thus at the state level, there is an extensive and on-going policy debate as to whether regulation should be should be integrated (single “peak”), or whether it should be divided according to regulatory objectives in a “twin peaks” model, in which prudential regulation is the responsibility of one regulator, and conduct of investment business the responsibility of another, or whether it should be divided on functional lines: banking, investments and investment services and insurance (mountain range).

In addition, in federal systems, there is variation in the distribution of regulatory functions between the federal and state or provincial governments. For example, in the US, banking regulation occurs at both levels but securities regulation operates at the federal level; whereas in Canada securities regulation operates at the provincial level and banking regulation at the federal level.

Finally there is variation in the distribution of regulation between state and non-state bodies, with some jurisdictions, such as Canada and the US, relying significantly on self-regulatory organisations, and others, such as Australia and increasingly the UK, where self regulatory bodies play much less of a role.

**Table 2. Varieties of regulatory structures**

Regulatory structure	Federal level / unitary state	State / Provincial level	SROs (other than exchanges)
<b>Functional (mountain range)</b>	US: securities US: some banking Canada: banking France: banking, securities	US: banking, insurance Canada: securities	US: securities Canada: securities
<b>“Twin Peaks”</b>	Australia: banking & securities		
<b>Integrated (single peak)</b>	UK Germany		UK: retail banking*
<b>Separate central bank</b>	UK Canada Australia EU: ECB members		

\* Historically, regulation of the banking-customer relationship has been based on common law and the Banking Code, administered by the British Bankers Association. The FSA will be taking over regulatory responsibility in this area in late 2009.

## **2.2 International and EU context of financial regulation and principles of quality regulation**

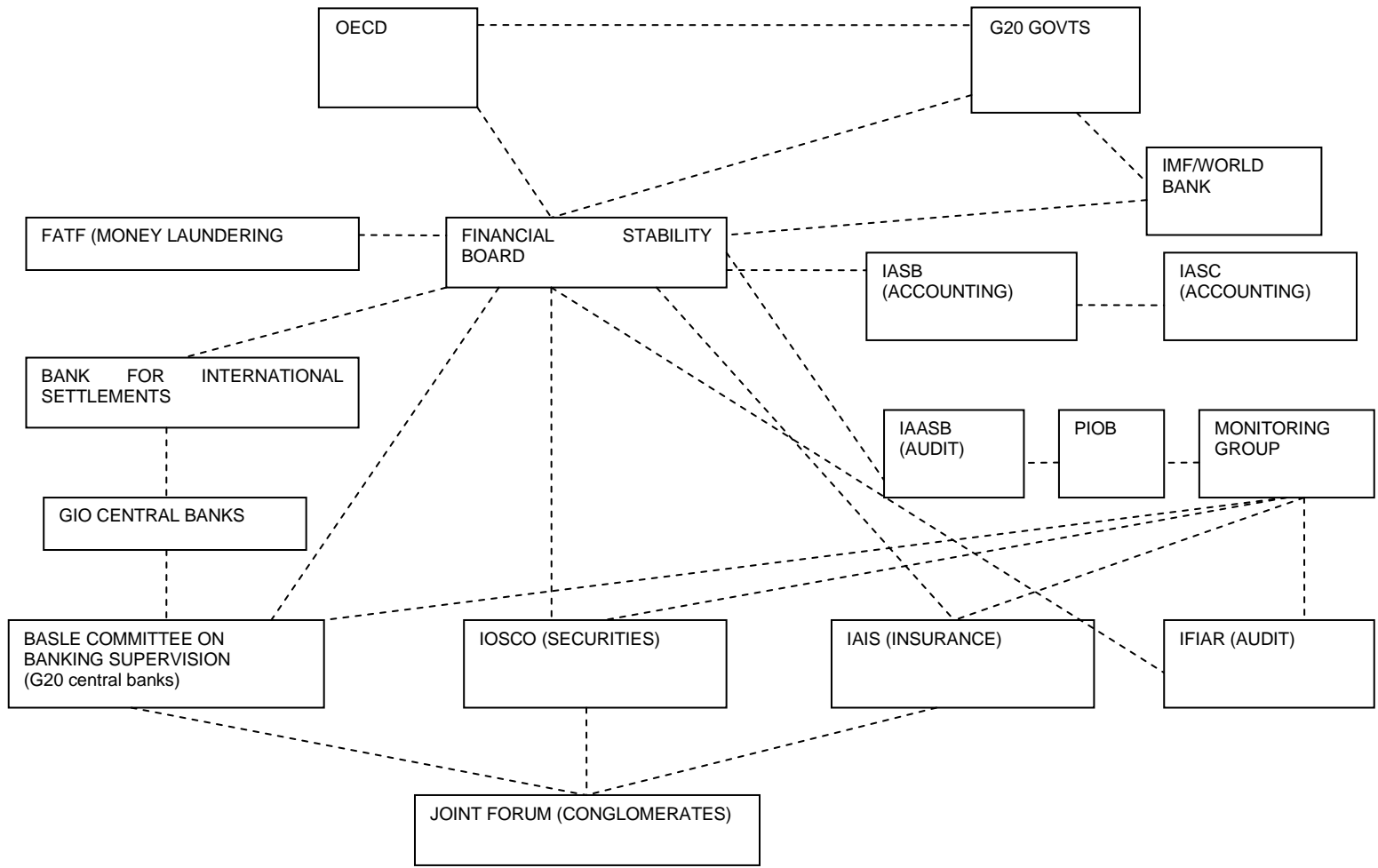
Financial regulation at the national level occurs within a framework set at the international level by the principal co-ordinating bodies<sup>3</sup>. These are divided on sectoral lines:

- Securities (IOSCO).
- Banking (BIS).
- Insurance (IAIS).
- Accounting (IASB).
- Audit (IAASB and IFIAR).
- Financial crime (FATF), its secretariat is based with the OECD.

The criteria for membership varies significantly between them. The body with the narrowest membership is the BIS, which is comprised of the central banks of the G10 countries. These bodies are themselves members of the supra-co-ordination body, the Financial Stability Forum (FSF), as is the European Central Bank, and in addition, the securities, banking and insurance committees co-ordinate through the Joint Forum in the provision of principles for regulating financial conglomerates (see Figure 1). Note that in March 2009 the FSF expanded its membership to include the G20 countries, and was renamed the Financial Stability Board. The Basle Committee on Banking Supervision, a committee of the BIS, also expanded its membership to include the G20 countries in September 2009. The IMF and World Bank play a role in jointly monitoring the conformance of countries' financial regulatory systems to a selection of codes produced by these bodies through their Report on Observation of Standards and Codes and Financial Sector Assessment Programmes.

These international bodies have issued principles relating to the organisation and key elements of their financial regulation to which countries are expected to conform. In the case of banking and securities these are the *Basle Core Principles for Effective Banking Supervision* and the *IOSCO Objectives and Principles of Securities Regulation*. In addition, the IMF As noted above, conformance of countries' financial regulatory systems with these and other principles<sup>4</sup> is monitored by the IMF and the World Bank, which have to date produced reports on over 100 countries.

Figure 1. Basic Structure of Global Financial Regulation, Regulation (adapted from Davies and Green (2008))





### 2.2.1 *Basle Core Principles*

The Basle Core Principles were initially agreed in 1997 as part of a global response to strengthen the international financial system in the wake of the financial crises in the 1980s and early 1990s (BCBS, 2006). The 25 Principles have been recently updated in 2006, and agreed by banking supervisors in 120 countries. The Principles are minimum standards for banking regulation and supervision, covering a wide range of aspects including areas such as licensing, ownership of banks, bank capital adequacy, risk management, consolidated supervision, ways to deal with problematic situations in banks, and the division of tasks and responsibilities between home and host authorities. The Core Principles Methodology, which was developed in 1999, provides further details and guidance to assist in the interpretation and assessment of the 25 Core Principles. Revisions to the code in 2006 focus in more depth on what constitutes sound risk management and corporate governance practices and the criteria dealing with the fight against money laundering and terrorist financing as well as fraud prevention have also been strengthened. In addition, the need for closer co-operation and information exchange between supervisors of different sectors and countries receives greater attention. The review also stresses the importance of the independence, accountability and transparency of bank supervisory authorities (BIS, 2006). The principles are reproduced in Annex B.

Many of the principles contain provisions which are specific to the banking sector. There are some principles of more generic application that might be broadly considered to be principles for “quality regulation” in any sector, however. These relate to operational independence, transparency, accountability, powers and supervisory skills. Thus Principle 1 provides that provide that a banking supervisor should possess “operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties”. It further provides that “a suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. They also require that arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place” (BCBS, 2006, Principle 1).

With respect to licensing and supervisory powers, Principle 2 provides that “the licensing authority must have the power to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the ownership structure and governance of the bank and its wider group, including the fitness and propriety of Board members and senior management, its strategic and operating plan, internal controls and risk management, and its projected financial condition, including its capital base. Where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.” Principle 23 provides that Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability, where appropriate, to revoke the banking licence or to recommend its revocation.

Finally, Principle 19 relates to the skills and knowledge of supervisors. The Principle requires that “supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups, and also of the banking system as a whole, focusing on safety and soundness, and the stability of the banking system.” Such a provision is not explicitly part of the *OECD Guiding Principles (in contrast to the PFEER)* but could be an interesting candidate for inclusion, obviously amended to require an understanding “of the sector being regulated” to render it of more generic application.

### 2.2.2 *IOSCO Objectives and Principles of Securities Regulation*

In the context of securities regulation, IOSCO has set out similar principles for the independence and transparency of securities regulators, and the requirement for them to have adequate powers, as well as sector specific provisions. Its 30 Principles were initially formulated in 1997, and re-issued in consolidated and updated form in 2002. The Principles are also accompanied by guidance on their implementation.

Principles 1-5 relate to the securities regulator, and require that its responsibilities should be clear and objectively stated; that it should be operationally independent and accountable in the exercise of its functions and powers; that it should have adequate powers, resources and capacity; adopt clear and consistent regulatory processes and observe the highest professional standards, including appropriate standards of confidentiality.

In addition, the Principles provide that regulators must have comprehensive inspection, investigation and surveillance powers, of which they are required to make credible use (IOSCO, Principles 8-10). They should have the powers to share information with other regulators nationally and cross-nationally, and should provide assistance to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers (IOSCO, Principles 11-13).

Finally, in recognition of the role often played by self regulatory organisations in securities regulation, the Principles provide that “appropriate use” should be made of SROs, who should be subject to oversight. Reflecting to an extent the traditionally different emphases of banking and securities regulation, there are no comparable provisions either on licensing, however, or to the requirement to develop an understanding of securities activities either on an institutional or systemic basis that appear on the BCBS Core Principles.

### 2.2.3 *Comparing the OECD General Guiding Principles, Basle and IOSCO Principles*

The 2005 *OECD Guiding Principles of Regulatory Quality and Performance* are obviously broader in scope than the sector specific principles. They address whole-of-government issues such as public services and the need to ensure regulation while promoting competitive market environments and liberalisation. They also contain specific provisions with respect to competition law and economic regulators.

However there are areas of overlap. The 2005 *OECD Guiding Principles of Regulatory Quality and Performance*, the IOSCO Principles and the Basle Core Principles have similar provisions relating to the clarity of legislative and policy goals, for example, and for the need for regulators to be transparent and accountable.

There are also areas of “underlap”. There are items in the 2005 *OECD Guiding Principles of Regulatory Quality and Performance* which could be applied in the sector-specific context. For example, the OECD RQP Principles contain requirements relating to the nature of the regulatory requirements and the provisions for their review and assessment which are not echoed in the sector specific Principles, though clearly would be equally applicable.

On the other hand, there are elements of the Basle and IOSCO Principles which could apply on a “whole-of-government” basis but are not particularly developed in the OECD RQP Principles. In particular, the Basle Principles focus to a far greater extent on risk management issues, which are largely absent from the OECD Principles. In addition, the BCBS Principles require that “supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups, and also of the banking system as a whole.” Such a provision for the need for a clear grasp of the dynamics of the organisations and system being regulated is not explicitly part of the OECD Principles on quality regulation but is an interesting candidate for inclusion, obviously amended to render it of more generic application.

There are also arguably omissions from all three sets of principles. Notable by its absence, for example, is a requirement for one of the key regulatory skills which has proved critical in financial regulation: the assessment of risk, and the integration of systemic risk evaluation into the assessments and regulatory requirements for individual financial institutions. Amended to render it of more generic application, such a principle would require, for example, that regulators develop an understanding of the implications of changes in the macro-environment for regulated firms and the system as a whole. Further, the principle on “co-ordination” which is included in the 2005 *OECD Guiding Principles of Regulatory Quality and Performance* could be expanded. The OECD Guiding Principles emphasise co-ordination with competition authorities, or with other areas of policy making. The co-ordination issue which has been critical in financial regulation however, is the co-ordination of regulators within the same policy domains, and with their counterparts in other countries. However, this is arguably not fully captured in the OECD Principles.

#### 2.2.4 *Policy Framework for Effective and Efficient Financial Regulation*

The OECD has recently adopted in 2009 a *Policy Framework for Effective and Efficient Financial Regulation (PFEEFR)*, which was under development when drafting this report. This policy framework identifies the main elements which are necessary for a sound financial regulation, and incorporates the existing 2005 *Guiding Principles for Regulatory Quality and Performance*, and the 1995 *Recommendation on Improving the Quality of Government Regulation*. It identifies the following elements:

- A good understanding of the features of the financial system, need for transparent operations, surveillance and analysis
- The clear articulation of policy objectives, including identification of problems and the case for intervention, clarity of the objectives, and consistency with micro-level objectives, as well as accountability in the way that these objectives are to be achieved.
- The identification of the range of policy instruments at the government’s disposal, and their potential uses, the need to match them with the objectives, as well as the principles of financial regulation, including *precaution, risk-based, sound incentives, comprehensiveness, consistency and competitive neutrality*. In this context it also makes explicit reference to the general requirements for High Quality Regulation, as well as the need for systematic review.
- The importance of the international dimension, including co-ordination, convergence and promotion of open competitive and safe markets.
- System design and implementation, including matching policy objectives and instruments to institution, co-ordination oversight and control of institutions.

The aim of the *PFEEFR* is to permit the specifics and commonalities of financial regulation in relation to other policy instruments to be more clearly identified and understood, and to provide a comprehensive framework for the development of sound approaches and principles for government intervention in the financial system as a whole. It includes key requirements for financial regulation, related to the nature of regulation, the regulatory process and enforcement, and the international dimension of financial regulation.

The *PFEEFR* focuses on the policy framework as well as developing guidance on regulatory approaches and principles. The OECD’s *Reference Checklist for Regulatory Decision Making* is focused on the development of new regulations in a generic manner. The *PFEEFR* includes a checklist to help policymakers in considering these latter principles.

The gaps identified above in the OECD's *Guiding Principles for Regulatory Quality and Performance* and the IOSCO and Basle Principles are filled by the *PFEFR*. Thus the *PFEFR* has specific provisions on the co-ordination, oversight and control of the regulatory institutions, on risk-based regulation, and on the need to ensure that macro concerns are integrated into the micro-evaluation of individual financial institutions. However, the *PFEFR* was not formally in place at the time of writing this report, and hence national authorities would not have been expected to be aware of this comprehensive presentation of requirements.

### **3. Independence and Accountability**

One of the fundamental tenets of the OECD's principles for quality regulation is that regulators should be transparent and accountable. This is also a requirement in the *PFEFR*. The Principles themselves do not refer to "independence" but the country-specific assessments which the OECD has done of regulatory agencies, do examine the nature and extent of their independence. The 2005 *OECD Guiding Principles of Regulatory Quality and Performance* covering accountability and transparency are echoed in the Basle and IOSCO principles, which in addition require that banking and securities regulators should be "operationally independent" (BCBS Core Principles, Principle 1; IOSCO Principles, Principle 2). This section explores what these concepts mean, and how they are reflected in the different regulatory regimes that are examined herein.

#### **3.1 Assessing independence**

In financial services, as in many other areas of economic regulation, authority to regulate has been delegated to regulatory agencies. One of the critical points of variation in the operation of these bodies is the relationship with, and independence from, other political institutions of the executive and the legislature. There are different definitions of "independence", but the understanding of independence adopted here is that the agency has the autonomy to determine its own preferences (*i.e.* decide what it wants to do) within the boundaries of its legal remit, and then can carry out those decisions without interventions from others, in other words without having to seek approval from government or any other body (Nordlinger, 1987, p. 361; Magetti, 2007).

The question then is how to assess independence, and for what purposes. Is it sufficient to look at the formal legal powers to identify where decision making power lies and with respect to a range of decisions, and if so which decisions? Such an analysis will tell us what decision making powers those who established the agencies wanted the agency to have, and what powers they wanted other parties to have, such as ministers, the legislature, courts or other bodies such as the prosecution services or consumer or labour organisations. Formal legal structures thus give us information about the initial decisions that were made, or at least formalised, concerning the distribution of powers of and relating to the agency, for example its board structure.

The distribution of formal powers only tells us so much, however. It may tell us of the choices that have been articulated in law, but it does not necessarily tell us how independent the agency is in practice in its day to day operations, either in normal times or in times of crisis. In formal terms, there might appear to be quite a high degree of independence, but it may be that informally the head of the agency follows closely the directions (or "guidance") of the Minister. Or the opposite may be the case: formally ministers or the legislature may have considerable powers, but in practice the agency is left to get on with things on its own terms. Powers of Parliament to approve rules may be merely a formality, for example, having no bearing on what the agency decides to do and only a minimal, procedural bearing on how it does it. Moreover, the map of formal powers does not tell us how independent the agency is from groups not mentioned on that map, and in particular, it does not tell us how independent it is in practice from those that it regulates.

Furthermore, independence is clearly something which is a matter of degree rather than one of binary coding. Regulators cannot be divided into those which are independent and those which are not, but rather into those which are more or less independent in different ways. Moving beyond this generalised assessment requires a structured and granular analysis, and measuring formal independence has become a burgeoning field of academic research. This work develops a series of indicators of independence to which different weights are assigned. Agencies, including central banks, are then assessed according to this “independence scorecard” and thus a formal measure of formal independence is arrived at. This work began in the context of assessing the independence of central banks (Cukierman *et al.* 1992; Alesina and Summers 1993; Grilli *et al.*, 1991). It has been expanded and developed by Gilardi (2002, 2008) and applied to regulators in utilities, other economic regulators and social regulators.

In one of the most ambitious and wide ranging studies of formal independence, Gilardi coded and assessed the independence of seven different regulators in 17 European countries (Gilardi, 2002, 2008).<sup>5</sup> On his scoring, financial regulators are measured as being less independent, in formal terms, than either electricity or telecoms regulators in most of the countries included in the analysis. Overall, his research found that variations in independence depend on three different groups of factors: the sector being regulated, the political and institutional context of different countries, and the history of independent regulators in particular countries or sectors. First, regulators in the utilities (electricity and telecoms) and economic sectors (pharmaceuticals and financial markets) tended to be more independent than those in the social sectors (food and the environment).<sup>6</sup> Secondly, regulatory agencies tend to be more independent in countries where the nature of the institutional context is such that there are few veto players (*e.g.* majority governments in unitary states) than those where there are many (*e.g.* coalition governments), and moreover where there is a high risk that governments will be replaced by another government with different preferences on a regular basis (Gilardi, 2008, 60-63).<sup>7</sup> Thirdly, the greater the number of regulatory agencies already existing in a country, the higher the probability that a new independent regulator will be set up.<sup>8</sup>

There are anomalies remaining from this analysis to which he draws attention. One which is relevant in the financial services context is that his findings on the relationship between independence and political and institutional factors were completely the opposite to those found by others for central banks. In the case of central banks, those which had a higher degree of formal independence were in countries where there was low replacement risk and a high number of veto players, whereas in the case of regulatory agencies, these features were associated with a low degree of formal independence.

As noted, Gilardi’s work focuses only on formal independence and does not look at how independent regulators are in practice. Formal structures can be undermined by close political relationships between the agency and ministers, for example; on the other hand, ministers may never use the formal powers which they possess.

Others have thus begun to develop indicators for “*de facto*” independence, in other words to identify what, in their view, one would expect from the day to day operations of an autonomous agency and to see to what degree these are present or not (see *e.g.* Thatcher, 2002). One of the more detailed analyses is that of Magetti, who has attempted to analyse the degree to which agencies are independent in practice both from politicians and from regulatees (Magetti, 2007).<sup>9</sup> The methodology is clearly limited in that it relies heavily on self-reporting by agencies with no or little triangulation to verify the assessments given. In particular, the assessments given by the regulator as to who was the main driver behind their policy and rule making cannot on its own be taken as providing reliable evidence of their *de facto* independence. Nonetheless the findings are interesting, even if in some respects they have to be treated with caution. With respect to independence from politicians, Magetti found, unsurprisingly, that high formal independence was neither a necessary nor, on its own, a sufficient condition for high *de facto* independence. Indeed, agencies could have a high degree of independence in practice even though their formal independence is

very low (Magetti 2008 at 279). Instead, he found that a high degree of independence in practice is associated with age and with the number of veto players. He found that the older the agency and the greater the number of veto players, the more the agency is independent in practice. However, formal institutional structures do matter to a degree. The relationship between old age, a high number of veto players and high *de facto* independence is increased where there is also a high degree of formal independence, even though the latter on its own has no significant effect.<sup>10</sup>

Independence is thus both difficult to assess in practice, and contingent on a number of institutional factors. As a principle of regulatory reform, it is possible to mandate formal independence, but it is not possible to insist or ensure that such agencies will be independent in practice for ensuring this may require fundamental changes in the entire political system and indeed political culture of a country.

### **3.2 *Independence of financial regulators***

There are a number of indicators of independence, and different studies place emphasis on different ones. The aim here is to disaggregate the notion of operational independence, and thus to examine independence with respect to the performance of the key regulatory functions. This section therefore considers the independence of the different regulators with respect to four main categories:

- Institutional structures and relationships.
- Independence in exercising key regulatory functions.
  - Licensing and rule making.
  - Monitoring and enforcement.
- Operational independence.
- Financial.

#### **3.2.1. *Institutional arrangements***

The institutional structures and relationship of the regulatory agencies and the executive are broadly similar in Australia, Canada and the UK. In each case the boards are appointed by the equivalent of the Minister of Finance for fixed terms, and are removable only on grounds specified in legislation. Each has a clear legislative mandate, even if it is administering several pieces of legislation, and a clear set of statutory objectives.

The notable difference between the countries is that in Australia the Minister has power to give both APRA and ASIC written directions about policies it should pursue, or priorities it should follow in performing or exercising its functions and powers under corporations legislation (s.12(1) ASIC Act) but should not give directions about a particular case nor about its staffing practices or policies or on issues relating to conflicts of interest (s.12(1) ASIC Act). Government policy is to only use this in rare and exceptional circumstances, however: it was last used with respect to ASIC's predecessor in 1992.

The relationship between Ministers and the agencies can also be set out in non-statutory documents. Both the FSA and the OSC have a Memorandum of Understanding with the Minister of Finance, and in the FSA's case, with the Bank of England as well, setting out their relationships in more detail (FSA, 2003; OSC, 2003). The OSC's MoU has to be renewed every five years.

In Australia, as part of the response to the Review of the Corporate Governance of Statutory Authorities and Office Holders (Uhrig, 2003) the Australian Government agreed that Ministers would issue Statements of Expectation to independent statutory agencies, and has done so with respect to both ASIC and APRA. This requires ASIC, amongst other things, to conform to the Government's principles on best practice in regulation, to adopt an outcomes-based approach to regulation, to adopt policies which minimise the burden on business, improve commercial certainty as to the administration of the legislation and to ensure that the regulatory framework does not unduly constrain competition and innovation. It clearly states that the Minister will ensure that ASIC has operational independence, but that it has to be mindful of the Government's economic policy objectives, and emphasises that responsibility for policy formation with respect to corporations and financial services lies with the Minister (Australian Treasurer, 2007).

The position of the US regulators is slightly different, partly because they operate in a Presidential not Parliamentary system. As a result, the legislature (in each case the Senate) has a greater role in appointments. The method of appointment of the heads and boards of each body is the same: they are appointed by the President and confirmed by the Senate for fixed terms which span Presidential and Congressional terms. Their formal status varies. The FRB, the SEC and the CFTC are independent agencies. The OCC is a bureau of the Treasury and under the general direction of the Secretary of the Treasury, though the latter has no delay or veto powers over the issuance of any rule or promulgation by the OCC. The Comptroller of the Currency is appointed by the President with the advice and consent of the Senate for a fixed term of 5 years. Deputy Comptrollers are appointed by the Secretary to the Treasury, who determines their salaries.

The chairmen of each of the FR, OCC, SEC and CFTC sit on the President's Working Group on Financial Markets, which is chaired by the Secretary to the Treasury. The Working Group reports its recommendations to the President on any legislative changes, and informally can block rule making by the individual regulators informally, but it has no formal powers with respect to any of them; its function is rather one of co-ordination. It can however exert significant influence over the rule making of its members, as discussed below (see GAO, 2007).

The most notable difference is with France, where the system of Board appointments is significantly different to those of the other countries. The AMF has a 16 member Board, six of which are appointed by the Minister of Finance in consultation with a number of organisations, and nine of which are appointed by different office holders within the state. The following are entitled to each appoint a Board member: the President (who appoints the Chairman); the Vice President of the *Conseil d'Etat*, the Chief Justice of the *Cour de Cassation*, the Auditor General of the *Cour des Comptes*; the Governor of the Banque de France; the Chairman of the *Conseil National de la Comptabilité*, the President of the Senate, the President of the National Assembly, and the Chairman of the *Conseil Economique et Social*. The Minister of Finance then appoints five members after consultation with organisations representing listed industrial and commercial companies, investment firms, market operators, clearing houses, settlement system managers and custodians, and one member after consultation with trade unions and industry associations. Finally, the Board also includes a Government Commissioner, who is Director General of the Treasury and Economic Policy Department. The Commission des Sanctions has 12 members: two counsellors each from the *Conseil d'Etat* and the *Cour de Cassation* from whom the members elect a Chairman; six experienced members from the industry appointed by the Minister of Finance and two representatives of financial sector employees (L.621-2). The Minister sits on the *Commission des Sanctions* as an observer (see IMF, 2005, p. 149 for comment).

### 3.2.2 *Independence in exercising key regulatory functions*

#### 3.2.2.1 Licensing and approvals

All the regulators examined here with the exception of OSFI are solely responsible for licensing and approving the financial institutions that they regulate. In Canada, licensing and approval powers of banks in Canada lie principally with the Minister of Finance, who in practice acts on advice of OSFI. Most Ministerial approvals relate to the acquisition of control or of a significant interest in federally regulated financial institutions, transfer of business or reinsurance transactions, and applications for the incorporation of financial institutions or the authorisation of Canadian branches of foreign financial institutions. OSFI approvals typically include reinsurance by related party, redemption of shares/debentures, substantial investment and others (OSFI, 2008).

With respect to markets and exchanges, the regulators in the US and the UK, and the OSC in Canada, have the powers to recognise markets and exchanges, but in Australia this power formally lies with the Treasurer.

#### 3.2.2.2 Rule making

Not all have powers to make secondary legislation, though all of the regulators have powers to interpret their legislation through issuing guidance. It can only issue guidance and exemptions (referred to as instruments and class orders); secondary rule making powers lie with the Governor General. In addition, class orders made by ASIC, which clarify the application of the law to certain classes of person and provide exemptions, are generally subject to disallowance by Parliament (ASIC, 2006).

In Canada, the OSC has powers to formulate rules but these must be approved by the Minister of Finance. The Lieutenant Governor in Council also has “backstop” powers to make rules which the OSC cannot unilaterally override. OSFI has no rule making powers but issues extensive guidance; the Basle capital rules were implemented through guidance, for example.

In France, the AMF has powers to make rules of general application, but these must be approved by the Minister of the Economy. This is seen by the AMF to be largely a formality (see IMF, 2005, p. 149).

The regulators in the US, the FSA, and APRA have powers to make rules which have legal effect independently of the executive. For example, APRA has powers to determine prudential standards which have legal effect for all deposit taking institutions, general insurers, and life insurers as well as subsidiaries and non-operating holding companies of those entities; the powers are exercisable without the approval of a Minister.<sup>11</sup> The FSA has extensive and complex rule making powers. It is entitled to impose legally binding requirements on authorised persons, and in some cases on unauthorised persons. These provisions are not subject to Parliamentary approval or approval by the Treasury. It also has the power to make evidential rules, to issue guidance, and to grant waivers. It can issue directions to recognised exchanges, clearing houses, professional bodies and the Lloyds insurance market. Breach of the FSA’s rules is subject to disciplinary action by the FSA. The FSA also has the power, in most instances, to determine which of its rules will be subject to a private right of action for their breach.<sup>12</sup>

Finally, in the US, under the Congressional Review Act every agency, including the independent agencies, has to submit their final rules and a cost-benefit analysis to Congress and to the GAO before the rule can take effect. Congress can pass a joint resolution opposing the rule, which the President can either accept or veto. In practice, no rule has yet been rejected by a joint resolution.



### 3.2.2.3 Monitoring and enforcement

The regulators have extensive powers of monitoring and enforcement which are exercisable without the approval of their relevant government departments. All have powers of entry, search and seizure though usually require court order for their exercise. With respect to ASIC, however, the minister may direct ASIC to investigate particular suspected breaches of the statutory requirements.<sup>13</sup> In the UK, some of the FSA's criminal investigation powers run concurrently with the Secretary of State. The AMF is required to co-ordinate with the central bank in its supervision of investment firms as the central bank has responsibility for their prudential regulation.

### 3.2.3 *Operational independence*

The statutory frameworks for the different regulators grant considerable operational independence to the different regulators with regards to human resources, internal organisation and procedures, and the development of strategic priorities.

There is variation in the extent to which Ministers are involved in approving business plans. OSC's business plan has to be approved by the Minister, although the recent FSAP found that the Minister has not used its economic powers to affect OSC priorities or decisions in any way. The agreement by the OSC of MOUs for exchange of information also requires the approval of the Minister of Finance.

### 3.2.4 *Financial independence*

There is some variation in the financial independence of the regulators.

The SEC, CFTC and ASIC are not financially independent. The SEC and CFTC are funded by appropriations from Congress. ASIC is funded by Parliament through the Commonwealth budget. ASIC imposes fees and charges on the regulated industry however, which in 2007-08 totalled AUD 545 m. This money goes to the Treasury; the amount ASIC received from Government was only AUD 274 m.

APRA is primarily funded by a levy on supervised entities, determined by the Australian Treasurer after industry consultation (this levy also funds ASIC and ATO in part). It can also charge for services provided, but these charges must reflect the costs of providing the services and therefore not amount of taxation.<sup>14</sup>

The OSC is funded mainly through fees paid by market participants. There are two types of fees, activity fees which are based on an estimate of the direct cost of the agency's staff resources used in undertaking its activities, and participation fees which are based on the cost of a broad range of services which cannot easily be attributed to individual activities or entities (OSC, 2008, pp.28-29). Its annual budget and business plan is subject to approval by Minister of Finance. However the recent FSAP on Canada found that although this could give the Minister the ability to restrict OSC's financial independence, in practice it does not. The AMF is also funded through fees but the level is determined by the Minister.

OSFI, the FSA and the FR regulators have the greatest degree of financial independence. All but the FR regulators are funded through fees, the level of which they set independently of the executive. The FR's income is derived primarily from the interest on US government securities that it has acquired through open market operations. Other sources of income are the interest on foreign currency investments held by the System; fees received for services provided to depository institutions, such as cheque clearing, funds transfers and automated clearing house operations; and interest on loans to depository institutions. After paying its expenses, the FR remits the rest of its earnings to the US Treasury.

**Table 3. Comparison of formal structures of independence**

Structure and functions	Regulator									
	USA				Canada		United Kingdom	Australia		France
	FR	OCC	SEC	CFTC	OSFI	OSC	FSA	APRA	ASIC	AMF
<b>Structure</b> - Appointments & Dismissal	Exec & Senate	Exec & Senate	Exec & Senate	Exec & Senate	Exec	Exec	Exec	Exec	Exec	Exec + 9 other state officers
- Executive power to give directions	No	No	No	No	No	No	No	√	√	√*
- MOUs with executive					No	√	√	√	√	
- Member of executive co-ordination body	√	√	√	√	√	√	√	√	√	√
<b>Functions</b> - Independent Powers of licensing and approval	√	√	√	√	No	√	√	√	√	√**
- Independent Powers to issue binding rules	√	√	√	√	No	No	√	√	No	No
- Independent Powers to issue guidance and waivers	√	√	√	√	√	√	√	√	√	√
- Independent Powers of monitoring and investigation	√	√	√	√	√	√	√	√	√	√***
- Independent Powers to impose administrative sanctions	√	√	√	√	√	√	√	√	√	√
- Independent Powers to prosecute	No	No	√	√	√	√	√	√	√	No
<b>Operational Independence</b> - Staffing	√	√	√	√	√	√	√	√	√	√
- Salary levels	√	√	√	√	√	√	√	√	√	√
<b>Financial Independence</b>	√	√	No	No	√	√	√	√	No	√

\* Minister sits on the Board.

\*\* For asset management firms; otherwise responsibility with CECEI on advice of AMF.

\*\*\* Co-ordinates with CB.

### 3.3 Accountability

To be accountable is to agree to subject oneself to relationships of external scrutiny which can have consequences (Bovens, 2007; Mashaw, 2007; Black, 2008). At its core, accountability is a particular type of relationship between different actors in which one gives account and another has the power or authority to impose consequences as a result (Bovens, 2007; Mashaw, 2007; Mulgan, 2000). In other words, for A to be accountable to B means that A agrees to external scrutiny by or on behalf of B (gives account to B) *and*

that B's response will make a "practical difference" to the conduct of A, either retrospectively, prospectively or both. These consequences may include sanctions. The presence or absence of sanctions, even informal ones, should not be decisive of the question of whether an accountability relationship exists; it simply distinguishes its form.

In analysing accountability arrangements, the same proviso has to be made as was noted with respect to the difference between formal independence and independence in practice. Mapping formal accountability arrangements is informative to an extent, but does not tell us where the power in the accountability relationships really lies, and indeed which accountability relationships are more influential in structuring the regulator's behaviour than others.

Nevertheless, in mapping accountability, there are four key questions that have to be addressed: accountability by whom, to whom, for what, and how.

#### **Box 1. Accountability: A framework for analysis**

##### **Analysing accountability**

###### Accountability of whom

- organisational
- individual officers & scope of immunity from liability

###### Accountability to whom:

- legislature,
- executive including national audit offices,
- judicial / specialist appeal body
- other "stakeholders": consumer, regulated firms
- other international bodies and / or regulatory peers in other countries

###### Accountability for what: accountability to ensure meet certain legitimacy criteria, summative legitimacy criteria:

- constitutional (conform to legal mandate, meet requirements of transparency, due process, etc.);
- functional (efficiency, use of financial resources, technical expertise, attainment of objectives, etc.),
- democratic (accountable to legislature, executive, other representative bodies; opportunities for participation by civil society etc) and
- performance – goal achievement

###### Accountability in what ways

- explanatory / justificatory – explain and justify actions / decisions
- amendatory – change decisions once made (e.g. decisions of appellate bodies)
- redress / compensatory – issue compensation for actions

The regulatory agencies have fairly similar accountability structures.

### 3.3.1 *Accountability of whom*

Individual officers in the regulators have statutory immunity from liability for all acts performed in good faith.

### 3.3.2 *Accountability to whom, how and for what*

#### 3.3.2.1 *Accountability to the executive*

All agencies are accountable to the executive in some way. All have to submit an annual report to the executive, which is published. All have the practice of publishing strategic plans whether formally required to or not.

There are some specific additional accountability structures for the different agencies. OSFI has a statutory obligation to report on the disclosure of information by banks and describing the progress made in enhancing the disclosure of information in the financial services industry.<sup>15</sup> It also has to produce an annual Department Performance Report to the executive, which is sent to Parliament. It is also worth noting that under the Bank Act, it is required to report on individual deposit taking institutions to the Minister. There is no such corresponding obligation on the FSA.

As noted above, the OSC has to submit its budget for approval to the Minister of Finance. The MoU between OSC and the Minister also provides that the fundamental principle of accountability will be observed in the management, administration and operations of the Commission. As an agency of the Government, the Commission agrees to abide by the management principles established by the Government of Ontario. These principles include ethical behaviour, accountability, excellence in management, wise use of public funds, high quality service to the public and fairness in the marketplace. It provides for a meeting with the Chair as necessary (at a minimum, once a year) to discuss issues relating to the effective discharge of the Commission's mandate and the need for services or support to be provided by the Ministry to the Commission. It also requires that the OSC's business plan meets the requirements set out in the Agency Establishment and Accountability Directive, which applies to all agencies in Ontario (OSC, 2006, Para 56).

In Australia, both ASIC and APRA are accountable to the Treasurer, and as noted the Treasurer under the previous government set out his expectations of APRA in the documents of *Statement of Expectations* (Treasurer of Australia, 2007)<sup>16</sup>. Both organisations are subject to the Financial Management and Accountability Act 1997 which, *inter alia*, sets out provisions relating to accounting, reporting and audit, modified in the case of APRA to reflect its independence in setting pay scales and the fact that it is funded through fees. Both ASIC and APRA are required to submit annual reports to Parliament.

OSFI and the OSC are under obligations to have their financial performance audited by the federal and provincial auditors respectively. In Australia, the ANAO performs a financial audit and also undertakes periodic reviews of APRA and ASIC's activities. For example an ANAO performance audit of APRA's Bank Prudential Supervision was undertaken in 2000-01 (Auditor General, 2001) and a performance audit of APRA's Prudential Supervision of Superannuation Entities was undertaken in 2003-04 (Auditor General, 2004). The ANAO assessed the effectiveness of ASIC's handling of statutory reports under the Corporations Act 2001 in 2006-07 (Auditor General, 2007). The focus of these is primarily on effectiveness rather than auditing its expenditure.

In the UK, the Board must have a non-executive committee which is under a statutory obligation to prepare a report on the discharge of its functions to be submitted to the Treasury with the FSA's annual report.<sup>17</sup> With respect to external audit, the FSA has not to date been subject to the NAO's jurisdiction, but the Government can request that the NAO undertake specific reviews of the FSA's performance. The NAO has undertaken two reviews of the FSA, the first assessing its performance in regulating money laundering, and the second investigating the extent to which the FSA complied with the "Hampton principles" which apply to all regulators in the UK (see below).

The AMF is financially accountable in that its accounts must be prepared by the *Agent comptable* (a civil servant from the Ministry of finance, named by the Minister in charge of budget, who is responsible for the receipts and payments made by the authority and who keeps the accounts of the AMF) (Art. 34 of the Decree 2003-1 109). These accounts also must be approved by the Board prior to their submission to the French National Audit Office (*Cour des Comptes*).

In the US, the regulators are subject to several levels of audit and review. Review of financial operations is conducted by the executive through the Treasury Department Office of the Inspector General (OIG). Established in 1989, the Treasury Office of Inspector General conducts and supervises audits and investigations of Treasury programs and operations; provides leadership and co-ordination and recommends policies for activities designed to (a) promote economy, efficiency, and effectiveness in the administration of Treasury programs and operations, and (b) prevent and detect fraud, waste, and abuse in Treasury programs and operations. It is also required to keep the Secretary and the Congress fully and currently informed about problems, abuses, and deficiencies in Treasury programs and operations.

The OIG conducts, co-ordinates and supervises independent audits and evaluations related to the agencies' internal programmes and operations, including those of the OCC. Evaluation extends beyond financial evaluation to consider the effectiveness of the agencies' operations, including audits of compliance with Federal laws, such as the Government Performance and Results Act (GPRA) of 1993. It also investigates programs and operations of the agencies and recommends policies to promote economy, efficiency, and effectiveness their programs and operations and to prevent fraud and abuse (for example OIG, 2002).

In addition to review by national audit bodies, the regulatory agencies can be subject to reviews by central government "better regulation" bodies to evaluate the extent to which they comply with better regulation principles in particular. These are discussed in Section 5.

### 3.3.2.2 Accountability to the legislature

All the regulators examined here are accountable to the legislature in that their senior officers can be called to appear before legislative committees. In addition, the Federal Reserve is accountable directly to Congress. Legislation requires that the Fed report annually on its activities to the Speaker of the House of Representatives, and twice annually on its plans for monetary policy to the banking committees of Congress. Fed officials also testify before Congress when requested. Further, the legislature in the US and France plays a role in board appointments.

It is worth noting that in Australia there is a specific Parliamentary Joint Committee on Corporations and Financial Services established by statute (ASIC Act, 2001) which has the responsibility of inquiring into and reporting to both Houses on the activities of ASIC, the Takeovers Panel and the operation of corporations law. The committee periodically reviews ASIC's activities through public and private hearings, and members of the committee also raise issues with ASIC individually.<sup>18</sup>

The activities of the other regulators can be subject to investigation and reports by the legislative committees established by the legislature itself. Both the US and UK legislative committees have held hearings and inquiries into the role of regulators in the current financial crisis, for example.<sup>19</sup>

In addition, in the US, all agencies in the US are subject to review by the Government Administrative Office (GAO), the investigative arm of Congress. The GAO supports the Congress in meeting its constitutional responsibilities and helps improve the performance and accountability of the federal government. The Federal Financial Management Improvement Act (FFMIA) of 1996 requires, among other things, that agencies implement and maintain financial management systems that substantially comply with federal financial management systems requirements. The GAO has issued a Core Financial Systems Requirements Checklist.

Reviews by the GAO of regulatory bodies often extend beyond issues relating to their financial management and extend in to their effectiveness, discussed further below. The GAO releases a biennial update to its list of federal programs, policies, and operations that are at “high risk” for waste, fraud, abuse, and mismanagement or in need of broad-based transformation. Notably, the report for 2008 notes “Modernizing the Outdated U.S. Financial Regulatory System” as a critical objective and blames the complexity of web of regulators a burden on the system (GAO, 2008). More specifically, the GAO has recommended, for example, that the OCC add more transparency and overcome impediments in the rulemaking process for implementation of the Basel II risk-based capital framework. GAO also suggested that the OCC could do more to address the needs of minority-owned financial institutions and recommended that the OCC measure the effectiveness of its program regularly (GAO, 2008).

### 3.3.2.3 Accountability to the judiciary

All the regulators examined here are accountable to the courts in that they are subject to public law principles of judicial review, and their enforcement decisions subject to appeal in the courts. In the UK there is a specialist tribunal, the Financial Services and Markets Tribunal, which hears appeals from the FSA’s enforcement decisions, and there is appeal from the Tribunal to the courts. The AMF has a separately constituted disciplinary body, and its decisions are subject to appeal to the courts.

### 3.3.2.4 Accountability to stakeholders

There is variation in the extent to which the regulators are subject to statutory consultation processes but in practice all the regulators engage in formal consultation. They publish draft regulations and draft policy statements, as well as comments on consultations and explanations of the final policies and rules adopted. As noted, they also publish annual reports and strategic plans.

Most of the regulators also have established consultative committees of stakeholders to advise them on developments in the market or on policy issues. These are generally comprised of industry representatives. There is more variation in the extent to which there are specific advisory groups on consumer issues. In the UK, the FSA has a standing Consumer Panel, which although funded and appointed by the FSA works independently from it. The FSA is required to inform the Panel of all policy initiatives and has a statutory obligation to give public written responses to the Consumer Panel’s comments on consultation proposals. The Panel has a separate budget and can undertake its own research, for example into the effectiveness of investor disclosures.

ASIC has a consumer advisory group which meets periodically. The AMF also has a Retail Investors Consultative Commission.

In Canada, the OSC had an investor advisory committee but this was disbanded after only two years and had no powers. The recent Expert Panel on Securities Regulation in Canada has recommended the establishment of an independent consumer panel, as well as consumer advisory groups for each provincial securities regulator.

In the US, the Federal Reserve has a Consumer Advisory Council, established in 1976, which advises the Board on the exercise of its responsibilities under the Consumer Credit Protection Act and on other matters in the area of consumer financial services. The SEC has an internal Office of Investor Education and Advocacy which is responsible for ensuring consumer issues are taken into account in policy making, but no separate consumer or investor advisory panel. The OCC has a number of consumer orientated policy initiatives (see for example OCC, 2007), but again no separate consumer or advisory panel; neither does the CFTC.

France has possibly the most elaborate system of advisory committees. It has set up five Consultative Commissions and a Scientific Advisory Board. The Scientific Advisory Board is composed of prominent academics and industry personnel. Its remit is to provide the AMF with more comprehensive information about ongoing research in the financial field, to identify developments that might have an impact on the AMF's areas of activity, and to research issues of concern to the regulator. The role of the five Consultative Commissions is to assist the AMF in its deliberations and help it to formulate policies. They are composed of experts appointed by the Board for a three year term, and are chaired by a member of the Board who co-ordinates their work programmes and reports back to the Board. Each commission has a specific area of competence, for example markets and exchanges, or collective investment schemes (AMF, 2007).

### *3.3.3 Internal systems of accountability*

Each regulator has some form of internal audit system.

OSFI has established mechanisms to ensure that day-to-day operations are in conformity with the strategic direction set up by the governing body. OSFI's Audit Committee was one of the first among Canadian government departments and agencies to have a majority of independent members, and meets frequently. The aim of the committee is to provide independent, objective advice, guidance and assurance to help OSFI efficiently and effectively achieve its business objectives and fulfil its mandate. The Committee exercises active oversight of core areas of OSFI's accountability, risk and control processes. It conducts assurance audits based on a comprehensive five-year, risk-based plan that is posted on the Web site, and also recommends for approval OSFI's financial statements, which are audited annually by the Office of the Auditor General (OSFI, 2008).

In the case of the OSC, its internal audit process involves the development of a matrix of risk and internal controls to identify areas where risks are not properly controlled. Based on this matrix correction plans are set up. In addition, in both cases the staff is required to present periodic reports of performance to the head of the organisation (IMF 2008a).

APRA has a Risk Management and Audit Committee which provides independent assurance and assistance to APRA's executive group on APRA's risk management and compliance framework and its external accountability responsibilities (APRA, 2008). There is also a Risk Assessment and Internal Audit Unit, independent of APRA's management. It focuses on identifying and assessing risks to APRA's activities and ensuring that adequate internal controls and processes are in place to manage these risks.

ASIC has an Audit Committee, whose aim is to maintain and improve the effectiveness and integrity of its risk management and internal controls, the credibility, objectivity and quality of its financial reporting and financial statements, and its compliance with relevant laws. The Audit Committee chairman, deputy chairman, and one other member are independent members appointed from outside of ASIC (ASIC, 2008).

The FSA has a committee of non-executive Board members, the chairman of which committee is appointed by the Treasury.<sup>20</sup> The non-executive committee is required by statute to carry out a range of functions including: keeping under review the question of whether the FSA is using its resources in an efficient and economic way, and whether it has adequate internal financial controls; determining the remuneration of the Authority's governing body and its executive members. The non-executive committee may appoint a sub-committee to perform this function, of which the chairman must be the chairman of the main committee, but whose members need not be drawn from it. The FSA also has an internal audit function. This produced a detailed report on the FSA's handling of Northern Rock in April 2008, which was made publicly available.

In the US, the SEC and CFTC have an internal Office of the Inspector General who performs internal audit and investigations of SEC programs and operations. It is charged with seeking to identify and mitigate operational risks, enhance government integrity, and improve the efficiency and effectiveness of SEC programs. The OCC has an internal unit called Enterprise Governance Unit (EG). EG unit also serves as liaison to the Treasury Office of the Inspector General, the Government Accountability Office (GAO), and the Office of Management and Budget. The FR also a number of levels of internal audit reviews are conducted by the Board's Office of the Inspector General.

#### 3.3.4 *Reviews by international bodies, academics and others*

Australia, Canada and the UK have all agreed to have their financial systems reviewed by the IMF under the Financial Sector Assessment Programme (FSAP). Canada was reviewed in 2007-08 (IMF, 2008a; 2008b); Australia in 2005-06 (IMF, 2006a; 2006b) and the UK in 2003 (IMF, 2003).

There have also been reviews conducted on the part of the IMF of the independence and accountability of financial regulators more generally, which have also covered the UK, Australia and Canada (Quintyn *et al.*, 2007).

There have been individual performance reviews of several of the regulators conducted by various national bodies.

Securities regulation in Canada has been the subject of a number of reviews by expert groups, some of which set up by the federal government. Some of these included extensive evaluations by academics of various aspects of the regulatory structures, policies and processes (Committee to Review the Structure of Securities Regulation in Canada – Wise Persons Committee, 2003; Crawford Panel, 2005; IDA Taskforce, 2006; Expert Panel, 2009).

Both APRA and the FSA have been subject to reviews following the collapse of significant financial institutions under their jurisdiction. The collapse of HIH insurance company in Australia in 2000 led to a Royal Commission report on APRA, conducted by the ex-Superintendent of OSFI, and to the introduction of APRA's current system of risk-based supervision (Palmer Report, 2002). The nationalisation of Northern Rock in the UK was the subject both of an internal audit report and a Parliamentary Select Committee report into the operations of the FSA (Treasury Select Committee, 2008; FSA, 2008).



In the US, the system of regulation has been the subject of review by a number of bodies. Most recently a report by McKinsey & Co, commissioned by the Mayor of New York, Michael Bloomberg and Senator Charles Schumer, recommended that the US adopt a “two-tier” principles based approach, developing a set of principles to guide the regulators in performing their roles and a set principles to guide firms (McKinsey, 2007). The previous administration had echoed these recommendations and proposed reforms to the system in its *Blueprint for a Modernized Financial Regulatory Structure* (US Treasury, 2008).

**Table 4. Accountability Relationships**

Accountability Relationship	Regulator									
	USA				Canada		Australia		UK	France
	FR	OCC	SEC	CFTC	OSFI	OSC	APRA	ASIC	FSA	AMF
<b>Executive</b>										
Strategic plan formally required	x	x	x	x	√	√	x	x	x	x
Annual report										
	√	√	√	√	√	√	√	√	√	√
<b>Legislature</b>										
Annual report	√	√	√	√	√	√	√	√	√	√
Committee hearings										
	√	√	√	√	√	√	√	√	√	√
<b>Audit*</b>										
Financial audit	√	√	√	√	√	√	√	√	√	√
Performance evaluative	√	√	√	√	√	√	√	√	√	√
<b>Courts</b>	√	√	√	√	√	√	√	√	√	√
<b>Stakeholders</b>										
Consultation	√	√	√	√	√	√	√	√	√	√
Consumer Panels	√**	x	x	x	x	x	x	√	√	√
Publication of reports, plans	√	√	√	√	√	√	√	√	√	√
International bodies - FSAP	x	x	x	x	√	√	√	√	√	√

\* Audit may formally be part of legislative or executive accountability.

\*\* Consumer advisory panel for consumer credit responsibilities.

#### **4. “Powers for High Quality Regulation”**

Studies which the OECD has done of the regulatory regimes in different countries examine the powers of regulatory agencies from the point of view of whether they are sufficient to enable regulators to deliver “high quality” regulation, (OECD, 2003, 2004, 2006) and the extent to which they conform to a selection of “better regulation” principles. This section examines the powers of the different regulatory authorities with respect to key regulatory functions, and then examines the extent to which “better regulation” principles and processes apply to the exercise of these powers.

This section examines the powers of the different regulatory bodies in more detail. These are grouped under the key regulatory functions

- Licensing.
- Rule making.
- Monitoring and investigation.
- Response – ability of the regulator to take corrective action *e.g.* adjustment of capital requirements; requiring behavioural / organisational changes / responding to crises.
- Enforcement.

##### **4.1 *Licensing / authorisation***

A central feature of financial regulation is that it is based on systems of licensing and authorisation: firms and individuals have to be authorised to conduct a specified range of activities. This makes financial regulation distinct from, for example, occupational health and safety regulators. As noted, the BCBS Core Principles require that banking supervisors have powers to license banks, though the IOSCO Principles have no parallel provision. The agencies examined here have licensing powers, with the exception of OSFI, noted above. The situation in France is also more complicated, as licensing is the responsibility of CECEI, who acts on the advice of the AMF with respect to investment firms, though AMF is wholly responsible for licensing of asset management firms.

The agencies thus perform a fundamental gate-keeping activity, determining who should be entitled to carry on those activities and who should not. It must be noted, however, that regulatory agencies operating within the EU are obliged under the passporting requirements to grant authorisation to any firm which is already authorised in any other member state.

The licensing regime is important as it often provides regulators with the power to place restrictions on the scope of business that the firm seeking authorisation can conduct. It is common within financial regulation for the award of a licence to be conditional on satisfying a “fit and proper” test: viz that the organisation is deemed “fit and proper” to hold a licence.

##### **4.2 *Rulemaking***

The BCBS and IOSCO Principles have no requirement that supervisors should have independent powers to make binding rules. In practice, whether this power exists varies significantly between regulators, though not necessarily between countries. As noted above, the US regulators, APRA and the FSA have independent rule making powers.

The OSC's powers are exercisable subject to the approval of the Ministry of Finance, as are those of the AMF. OSFI implements its provisions through guidance. ASIC has no rule making powers, but issues regulatory guides, instruments and class orders.<sup>21</sup>

The US regulators and the FSA all have powers to issue a wide range of rules and guidance without approval by the executive or legislature.

#### **4.3 *Monitoring and investigation***

The BCBS and IOSCO Principles both require supervisors to have powers of monitoring, investigation and enforcement.

All the agencies have considerable powers of investigation. They can conduct on-site inspections, demand access to and obtain books and records without judicial intervention, though usually require a warrant before then can enter premises; they can require explanations and information from authorised persons and their auditors. In the UK, some of the FSA's enforcement powers run concurrently with the Secretary of State for Business, Enterprise and Regulatory Reform.<sup>22</sup> In France, the AMF and the CB are required to co-ordinate their inspections and monitoring of investment firms, as both supervise the same institutions though for different purposes.

There are particular provisions relating to the use of information obtained under compulsion, which vary with the requirements of the criminal and human rights regimes in operation in the different countries. For example, in the UK evidence obtained from a person under compulsion cannot be used directly against them in criminal proceedings. In Canada, in the case of the OSC, information obtained through compulsory powers (for example bank accounts of a non-regulated entity) can only be shared if the Commission orders so, prior notification is given to the party that provided the information and an opportunity is given for that party to be heard.

The extent to which agencies are permitted to share information with other national regulators obtained during investigations varies. Most can share information with other regulators for the purpose of enforcement. In the case of the OSC, however, some restrictions apply to the exchange of information obtained under compulsion.<sup>23</sup> The Minister of Finance also has to agree to any MoU relating to the sharing of information with any other regulator.

In general, there is an increasing practice between the major financial regulators in the world of entering into information sharing agreements.

#### **4.4 *Monitoring – Risk-based approaches***

The regulators have to varying degrees adopted risk-based approaches to monitoring. The OCC, OSFI, APRA and the FSA have elaborate and well structured systems of risk-based supervision; the SEC also has a form of risk-based supervision. OSC has a less complex structure, based on the self assessment of advisers and fund managers.<sup>24</sup> The AMF has recently introduced a risk-based approach based on the FSA's *ARROW* model. ASIC is in the process of revising and enhancing its risk-based approach.

#### **4.5 *Response & Enforcement***

The power of regulators to take corrective action, or require firms to take corrective action, and to take enforcement action is critical to their capacity to regulate effectively. The regulators vary in the extent to which they have distinct powers to take corrective action or require firms to do so. Furthermore, one important issue with respect to banks, which the financial crisis is bringing to the fore, is whether the regulator has the power to take action to manage a bank which is insolvent or on the verge of becoming insolvent.

There is considerable variation in the enforcement powers of the different regulators. All have powers to commence civil proceedings for various penalties, such as disqualification of directors or the imposition of fines, and to seek injunctions from the court.

Most have some administrative powers of enforcement, at the minimum the cancellation of a licence, and with respect to market regulators, to order the cessation of trading and freezing of assets (OSC and FSA). In some cases these are quite minimal.

The US regulators, AMF, OSFI and the FSA have the most extensive administrative enforcement powers. OSFI can require the payment of fines, and it can also disqualify and remove directors and senior officers of the bank is of the opinion that, on the basis of the competence, business record, experience, conduct or character of a person, he or she is not suitable to hold that position, or for contravention of regulatory requirements or contribution to contravention through action or negligence.<sup>25</sup> It must give notice and hear representations and there is a right of appeal to the court. OSFI also has a range of powers to require corrective action. The Superintendent may enter into an agreement, called a “prudential agreement”, with a bank for the purposes of implementing any measure designed to maintain or improve its safety and soundness.<sup>26</sup> It can also issue directions of compliance. Where, in the opinion of the Superintendent, a bank, or a person with respect to a bank, is committing, or is about to commit, an act that is an unsafe or unsound practice in conducting the business of the bank, or is pursuing or is about to pursue any course of conduct that is an unsafe or unsound practice in conducting the business of the bank, the Superintendent may direct the bank or person to cease or refrain from committing the act or pursuing the course of conduct or perform such acts as in the opinion of the Superintendent are necessary to remedy the situation.<sup>27</sup> OSFI can apply to court for enforcement of the prudential agreement or directions of compliance. It has no powers to impose fines, but can take temporarily take over a failing bank or request a winding up order (OSFI Guide to Intervention).

In contrast, the OSC has only limited administrative enforcement powers, and no specific powers of corrective action other than the threat of formal enforcement action.

The FSA has extensive enforcement powers and it has set out detailed guidance in the Handbook as to how these powers will be exercised.<sup>28</sup> It has the power:

- to prohibit individuals from performing regulated activities if it considers that they are not “fit and proper”;<sup>29</sup>
- to impose unlimited financial penalties on authorised persons;
- to make public statements of misconduct for breaches of any requirement made by or under the Act;<sup>30</sup>
- to impose restitution orders against authorised persons;<sup>31</sup>
- to make prohibition orders against those who have breached the “fit and proper” requirement;<sup>32</sup>
- to bring prosecutions (in England, Wales and Northern Ireland) for all criminal offences created under the Act, and additionally to prosecute offences of insider dealing contrary to Part V of the Criminal Justice Act 1993 and breaches of money laundering regulations.

The exercise of these powers is subject to statutory requirements on notice and hearings, and decisions are made by the Regulatory Decisions Committee, which following a restructuring of the FSA's enforcement process has now been made more operationally independent. The FSA may also apply to the court with respect to breaches of its own rules and other "relevant requirements", including the offences of market abuse, insider dealing and money laundering, for injunctions, restitution and "freezing" orders.<sup>33</sup> The FSA does not have comparable powers to APRA, or indeed to the UK competition authority, to enter into enforceable undertakings with regulated firms.

Only the FSA has powers to bring criminal proceedings itself for all breaches of the criminal provisions in the statutes it administers. ASIC can however prosecute minor regulatory offences itself, otherwise it initiates prosecutions but the final decision as to whether to prosecute is made by the Director of Public Prosecution (ASIC, 2006). All the other regulators must refer the matter to the criminal prosecuting authorities.

The AMF also has a wide range of enforcement powers. It can impose fines, suspend authorisations, require cessation of violations, seek and seize records and freeze assets (regardless of who is holding them) through court order, and refer misconduct for criminal prosecution (L.621- 14 &15). Clear obstruction of the investigations carried out by the regulatory authority or the provision of false information is an administrative and a criminal offense. It can impose fines of up to Euro 1.5m and ten times profits. The SEC also has an extensive range of administrative, civil and criminal powers. Most of the SEC's enforcement actions are brought in administrative proceedings, rather than as judicial injunctive actions. They include the following:

- Stop offering.
- Suspend trading
  - SEC can summarily suspend trading of a publicly traded security for up to ten days.
- Cease and desist orders.
- Compliance orders.
- Disgorgement orders
  - Forfeiture of profits by a person in violation of securities laws.
- Bar Corporate Officials
  - Under Sarbanes-Oxley, authorised to bar officers and directors from serving companies for violations in the sale of securities.
- Review disciplinary sanctions imposed by SROs
  - SEC may review sanctions by SROs (stock exchanges & its members).

In addition, each of the federal securities laws authorises the SEC to seek action in federal district courts against violations. Relief sought by the SEC includes the following:

- Injunctions (temporary restraining orders).
- Disgorgement of ill-gotten gains.

Court-granted injunctions in SEC actions reflect a judicial finding that there has been a violation and that the enjoined party has a propensity to violate them again the federal securities laws. Judicial findings in injunction action may be used collaterally and are binding in subsequent private litigation. Once a court has found a violation of the securities laws the factual and legal findings underlying the court's decision may be used affirmatively by private litigants in lawsuits seeking money damages (Palmiter, 2005).

To supplement the SEC's civil enforcement authority, the SEC works closely with the U.S. Department of Justice and law enforcement agencies around the world to bring criminal cases when appropriate. The Sarbanes-Oxley Act has criminalised certain violations of federal securities laws.

The CFTC has a similar range of powers. Administrative sanctions include:

- Suspending, denying, or restricting registration and exchange trading privileges.
- Imposing civil monetary penalties.
- Cease and desist orders.
- Orders of restitution.
- Temporary Restraining Orders.
- Appointment of a receiver.
- Freezing of assets.

The OCC and the FR also have powers to issue cease and desist orders, removal and prohibition orders, civil money penalties, and written agreements. Agencies refer criminal matters to the Department of Justice for prosecution.

In Australia, in some respects APRA has more extensive powers than ASIC. APRA has powers to issue directions which specify how an entity should resolve compliance issues and therefore enable APRA to compel an entity to take specific action to address prudential risks that have been identified.<sup>34</sup> It can also enter into court-enforceable undertakings with those it supervises. This power enables APRA to formalise and, if necessary, enforce an agreement that is reached with market participants. The Banking Act and the Insurance Act enables APRA to accept an enforceable undertaking that relates to a matter regarding which APRA has a function or power under the Act.<sup>35</sup> In common with OSFI and the other regulators examined here, APRA has the power to seek a court injunction to protect relevant interests in very serious cases and where other enforcement powers are insufficient.<sup>36</sup> ASIC's administrative enforcement powers are more limited. It can suspend or revoke licences, but for the imposition of civil penalties has to go through the court.

Having enforcement powers is obviously not the same as using them, and there have been concerns expressed that the regulators are not sufficiently effective in enforcing the regulatory requirements. There have been a number of studies comparing the intensity of the SEC's enforcement approach to that of the FSA, for example, which have noted the far greater resources dedicated to enforcement by the SEC and the much higher incidence of formal enforcement actions and levels of fines imposed (Jackson, 2007; Jackson and Roe, 2008; Coffee, 2007). The counter-view is that formal enforcement action is only one indicator of enforcement activity, and that the "compliance-orientated" approach favoured in general by non-US regulators can also be effective (Baldwin and Cave, 1999, for discussion). The FSA have recently significantly increased the resources of their enforcement division, however.

There have also been persistent concerns relating to enforcement of securities laws in Canada. The FSAP review of Canada, for example, commented with respect to enforcement by the OSC that although enforcement had experienced “positive change” during recent years, it was still “in need of considerable improvement.” It found that criminal enforcement was particularly weak, a finding echoed in other reports (IMF 2008a). Very few cases have been taken for criminal prosecution and even fewer have resulted in criminal sanctions. Enforcement by the provincial regulators had also been subject to criticism, in particular the lack of sufficient resources, the low level of sanctions imposed and the length of the administrative procedures. It commented that the development of a co-ordinated approach to enforcement between criminal and securities law enforcement, with clear lines of accountability and benchmarks, seemed to be missing, though the federal authorities and the provincial regulators have taken important steps in that direction” (IMF 2008a, p.28).

Both OSFI and APRA are notable for their categorisation of firms based not just on risk, but on the type of enforcement approach that should be taken to them. OSFI has a “staging” scheme for “structured early intervention”. However the FSAP on Canada suggested that this gave too much discretion to OSFI and that “transparency would be buttressed by reducing the room for discretion and forbearance in bank intervention and resolution. Currently, the “structured early intervention” regime provides for, but does not mandate, specific supervisory actions as certain capital thresholds are breached. Clearly there is a balance here between supervisory discretion and operational independence and communication to stakeholders as to what the policy is in exercising that discretion” (IMF, 2006b).

APRA has a more structured system of intervention, the Supervisory Oversight and Response System, which is linked into the risk scores given under the its risk-based system of monitoring and supervision (PAIRS – the Probability and Impact Rating System).

These approaches are worth noting, as one of the recent criticisms of the FSA, for example with respect to HBOS, was that it was too slow to impose corrective action even when it was aware of the bank’s situation. One of the significant shifts in regulatory approach that we can expect coming out of the financial crisis is a much more active approach to requiring firms to take corrective action, and a tougher stance on enforcement.<sup>37</sup>

## **5. Maximising the quality of regulatory power – “better regulation” arrangements**

Regulators are subject to a network of “*better regulation*” norms which are often only loosely co-ordinated, if at all. These include those emanating from the OECD, the BCBS, IOSCO as well as from their own national governments. This report does not purport to assess the conformity of each regulator to each of these principles. Conformance to the BCBS and IOSCO principles is already performed by the IMF and World Bank, for example. Rather this report focuses on those general principles for quality regulation elaborated by the OECD, selecting for attention those which relate most closely to the specific regulatory tasks.

As noted above, the 2005 *OECD Guiding Principles of Regulatory Quality and Performance* (OECD, 2005) provide that good regulation should:

- serve clearly identified policy goals, and be effective in achieving those goals;
- have a sound legal and empirical basis;
- produce benefits that justify costs, considering the distribution of effects across society and taking economic, environmental and social effects into account;

- minimise costs and market distortions;
- promote innovation through market incentives and goal-based approaches;
- be clear, simple, and practical for users;
- be consistent with other regulations and policies; and
- be compatible as far as possible with competition, trade and investment-facilitating principles at domestic and international levels.

The dimensions that are relevant in the context of OECD principles also include access to information, transparency, and the extent to which they make clear, consistent and predictable decisions (OECD, 2003, 2004, 2006).

Notable by its absence from these lists, however, which are cross-sectoral, is one of the key regulatory skills which has proved critical in financial regulation: the assessment of risk, and the integration of systemic risk evaluation into the assessments and regulatory requirements for individual financial institutions. Further, as discussed below, the “co-ordination” that the 2005 OECD *Guiding Principles of Regulatory Quality and Performance* emphasise is co-ordination with competition authorities, or with other areas of policy making at a domestic level. The co-ordination issue which has been critical in financial regulation however, is the co-ordination of regulators within the same policy domains, and with their counterparts in other countries.

This report draws on the 2005 *OECD Guiding Principles of Regulatory Quality and Performance* and previous country-specific reports to identify five particular areas for attention. In addition to the areas focused on in the country specific reports (OECD, 2003, 2004, 2006), this report also focuses on the issue of integrity, emphasised in the OECD’s Principles as well as in related OECD work on public governance<sup>38</sup> by examining the formal arrangements for managing conflicts of interest between the regulatory officials and those they are regulating. This section therefore examines the extent to which the financial regulators focused on key dimensions of regulatory quality, *ex ante* and *ex post*, in terms of transparency, coordination, as well as the improvement of regulation over time and the regulation of conflicts of interest.

In so doing, it will identify agency specific principles which are mandated in its own legislation or which have been voluntarily adopted by the agency, and cross-national principles and practices which apply to other regulatory agencies in that particular country or province. First, however, the next section outlines the “whole-of-government” structures that exist within the governments of each country for ensuring regulatory quality.

## **5.1 Executive “whole-of-government” structures for ensuring regulatory quality**

The US, UK, Canada and Australian governments all have a central body within the executive responsible for regulatory quality.

### **5.1.1 US**

There are two sources of “whole-of-government” structures for regulatory review: Congress and the central executive.



Under the Congressional Review Act, every agency, including the independent agencies, has to submit their final rules and a cost-benefit analysis to Congress and to the GAO before the rule can take effect. The reports are often quite brief. The submission has to state whether the rule is a “major” rule, *i.e.* of specified economic significance, and if so the GAO has to provide a report on the rule to the agency’s authorising committee in Congress, and the rule cannot take effect for 60 days after the report was sent to Congress or the rule is published in the Federal Register, whichever is the later.<sup>39</sup> The President can override the 60 day rule in certain specified circumstances, such as national emergency. The President can also veto a joint resolution opposing the rule. In practice, no rule has been disapproved by Congress.

Within the executive, the bodies which oversee regulation across the whole-of-government are the Office of Management and Budget (OMB), and within that the Office of Information and Regulatory Affairs (OIRA). Through successive Executive Orders the executive requires that agencies, including the financial regulators, submit their proposals for central review. The precise requirements are in a state of transition under the new Obama administration, so this section will detail the situation prior to January 2009.

Within the OMB, the OIRA is the main organisation which is the repository of regulatory expertise, including methodologies and procedures that affect more than one agency. The procedures were set out in executive orders, principally Executive Order (12866) On Regulatory Planning and Review, September 30, amended by Executive Order 13422 of 2007, which requires independent agencies to co-ordinate their regulatory efforts with the Office of Management and Budget. However, Congress has prohibited the OMB from spending federal money on Executive Order 13422 (2007) (Abrahams, 2007). The OMB includes regulation from the independent agencies in its costs-benefits regulatory report to Congress (OMB, 2008). On January 30, 2009, President Barack Obama signed Executive Order 13497 which revoked Executive Order 13422.

The objectives of Executive Order 12866 are to “enhance planning and co-ordination with respect to both new and existing regulations; to reaffirm the primacy of Federal agencies in the regulatory decision-making process; to restore the integrity and legitimacy of regulatory review and oversight; and to make the process more accessible and open to the public. In pursuing these objectives, the regulatory process shall be conducted so as to meet applicable statutory requirements and with due regard to the discretion that has been entrusted to the Federal agencies.”

The independent regulatory agencies were only subject to part of the Orders. They were required to follow the “regulatory philosophy” and the “twelve principles” of regulation, to conform to the “unified regulatory agenda” and to submit their “regulatory plans”. However they were not subject to the provisions on centralised review of regulations by OIRA, which applied only to executive agencies. This had long been a subject of critical comment by academics, including Professor Cass Sunstein, who was appointed head of OIRA in 2009 (Pildes and Sunstein, 1995, 2002; Hahn and Litan, 2004).

The “regulatory philosophy” to which federal agencies, including the independent regulatory agencies were meant to adhere followed the dominant regulatory philosophy which has prevailed for the last two to three decades, and indeed that reflected in the OECD’s Principles, *viz.* that regulation should only be used where there is a “compelling public need”, such as market failure, protection of health or safety or the environment, or the “well-being” of the people. Alternatives should be considered, including “doing nothing”, and proposals should be subject to a cost-benefit analysis, including quantitative and qualitative measures, and proposals should only be pursued where these will result in a net benefit to society (EO 12 866 Section 1).

The “Twelve Principles” were meant to be followed in order to further this philosophy. Again, these principles are similar to those adopted by the UK, Canada, Australia and the OECD. These were (paraphrasing) (EO 12866 Section 1):

1. To identify the problem and its significance
2. To identify whether existing laws or regulations have contributed to the problem and if so how to amend / remove them
3. Identify and assess alternatives to direct regulation, including information provision and economic incentives;
4. In setting priorities, agencies should consider the degree and nature of risks related to activities within its jurisdiction;
5. Design its regulations in the most cost-efficient manner, taking into consideration incentives for innovation, consistency, predictability, costs of enforcement and compliance (to government, the regulated and the public), flexibility, distributive impacts and equality;
6. Regulations should produce benefits which justify the costs;
7. Decisions to be based on the best reasonably obtainable scientific, technical and other information concerning the need for and consequences of the regulation;
8. Identify and assess alternative forms of regulation and specify performance targets for regulated entities to achieve rather than specifying the manner of compliance;
9. Requirement for co-ordination with other federal, state or tribal government bodies, policies and programmes;
10. Avoid regulations which are inconsistent, incompatible or duplicative with its own regulations or those of another federal agency;
11. Tailor regulations to impose the least burden on society, taking into account the cumulative effect of regulations;
12. Regulations to be drafted in a manner which is simple and easy to understand, and which reduces the scope for legal uncertainty and litigation arising from that uncertainty.

Executive Order 13422 extended the provisions of EO 12866 to cover guidance as well as regulations, and also enhanced the OMB’s control over executive agencies by prohibiting the adoption of a regulation or guidance without its approval, save in specified circumstances.

Independent regulatory agencies (including the FR, SEC and CFTC, though not the OCC) remained exempt from these detailed scrutiny procedures. However, as noted above, they did need to comply with the regulatory philosophy and principles, and the provisions concerning the Unified Regulatory Agenda and The Regulatory Plan (OMB, 2007). Each year, the federal agencies had to submit a “Regulatory Plan” to the OMB of the most important “significant regulatory actions” that the agency reasonably expects to issue in proposed or final form that fiscal year or the year after. Unless specifically authorised by the head of the agency, no rulemaking shall commence or be included in the Plan without the approval of the agency’s Regulatory Policy Officer (OMB, 2007).

A “significant regulatory action” was defined as a rule which may:

- Have an annual effect on the economy of \$100 million or more or adversely affect in a material way the economy, a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or State, local, or tribal governments or communities;
- Create a serious inconsistency or otherwise interfere with an action taken or planned by another agency;
- Materially alter the budgetary impact of entitlements, grants, user fees, or loan programs or the rights and obligations of recipients thereof; or
- Raise novel legal or policy issues arising out of legal mandates, the President’s priorities, or the principles set forth in the Executive order<sup>40</sup>.

Included in the Plan were

- The agency’s regulatory objectives and priorities and how they relate to the President’s Priorities
- Summary of each planned significant regulatory action
  - Alternatives considered
  - Estimates of costs and benefits
- Summary of legal basis of each action
- Statement of the need for each action
- Schedule for action
- Contact information of a person the public may contact for additional information

OIRA then was required to do the following:

- Circulate plan to other affected agencies
- An agency head who believes that a planned regulatory action conflicts with its own policy was required to notify OIRA Administrator in writing
- OIRA Administrator would forward the communication to the issuing agency if conflicts arise with other agencies or it is inconsistent with the President’s Priorities.
- The Unified Regulatory Agenda was published annually in October and made available to all levels of government and to the public
- The OIRA Administrator was required to convene a Working Group to discuss and commission studies on proposed regulation

The Orders also set out guidelines on regulatory impact analysis and the guidance that Federal agencies develop and provide to the public.<sup>41</sup>

The independent agencies are required to comply with other legislative requirements for quality regulation, however. Of note are the Regulatory Flexibility Act (1980) under which agencies must consider the impact of those rules on small businesses. The agencies must certify that actions taken will not have a significant impact on a substantial number of small entities. In addition, the Economic Growth and Regulatory Paperwork Reduction Act 1996 requires that federal agencies, including those considered here, review their regulations every 10 years to identify and eliminate any unnecessary requirements. During 2007, for example, the FR, the OCC, the Federal Deposit Insurance Commission and the Office of Thrift Supervision completed the required review and issued a joint report to Congress. The collection of information in rules must also be reviewed and approved by the Office of Management and Budget.

It is notable that the OCC was subject to the Executive Orders requiring cost-benefit analysis and scrutiny by OIRA. Thus the OCC conducted and submitted a regulatory impact analysis of the Basle II capital requirements in 2007, for example, which was then incorporated into the joint rule making notice of the federal banking regulators (OCC, 2006) (see Section 5.1.2.2 below).

### 5.1.2 Australia

The Australian Government has highlighted regulatory reform as a national economic policy priority by according it portfolio Cabinet-level status through the Minister for Finance and Deregulation. Responsibility for regulatory reform lies with the Department of Finance and Deregulation, a central agency of the Australian Government and one which has a limited regulatory role itself, minimising any conflicts the Department and its ministers may have in providing robust criticism of regulatory proposals.

The Department delivers two key functions in delivering regulatory reform: providing advice and assistance in developing regulatory policy through the Deregulation Policy Division; and providing quality assurance of regulatory impact assessments through the incorporation of the Office of Best Practice Regulation (OBPR) into the Department of Finance and Deregulation. The Deregulation Policy Division provides advice to the Australian Government on the regulatory management framework and on the policy merits of major regulatory proposals. In performing its role, the OBPR is concerned only with the standard of analysis undertaken. The OBPR does not have a role in commenting on the policy merits of proposals. Further details of the role of the OBPR are presented below.

Following the recommendations made in *Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business*, Australia strengthened its centralised process for overseeing regulatory quality at the federal level. Under this framework, the OPBR has a dual role of assisting departments and agencies in meeting the Government's requirements, and in monitoring and reporting on compliance with the requirements.

According to its charter, the role of the OBPR is to promote the Australian Government's objective of effective and efficient legislation and regulations. Its functions are to:

- Advise Government, departments and agencies on appropriate quality control mechanisms for the development of regulatory proposals and for the review of existing regulations;
- Examine Regulation Impact Statements and advise whether they meet the Government's requirements and provide an adequate level of analysis, including cost-benefit and risk analysis of appropriate quality;
- Advise departments and agencies on the Government's requirements for compliance costs assessment, and maintain the Business Cost Calculator as a regulation costing tool;

- Manage other regulatory mechanisms, including Annual Regulatory Plans and Regulatory Performance Indicators;
- Promote the whole-of-government consultation principles and provide clear guidance on best practice consultation with stakeholders to be undertaken as part of the policy development process;
- Provide training and guidance to officials to assist them in meeting the assessment requirements to justify regulatory proposals;
- Provide technical assistance to officials on cost-benefit analysis and consultation processes;
- Report annually on compliance with the Government's requirements for Regulation Impact Statements, compliance cost assessment and consultation, and on regulatory reform developments generally;
- Provide advice to ministerial councils and national standard-setting bodies on Council of Australian Governments guidelines that apply when such bodies make regulations;
- Monitor regulatory reform developments in the states and territories, and in other countries, in order to assess their relevance to Australia; and
- Lodge submissions and publish reports on regulatory issues having significant implications.<sup>42</sup>

The OBPR is to focus its efforts on regulations that restrict competition, have a significant impact on business and individuals or involve medium compliance costs. The OBPR is to ensure that effects on small business of proposed new and amended legislation and regulations are made explicit and given adequate consideration.

The Australian government's *Best Practice Regulation Handbook*, sets out best practice regulation requirements in line with these principles. Compliance with the procedures and processes outlined in the *Handbook* is mandatory for all Australian government departments, agencies, statutory authorities and boards that make, review or reform regulations. This includes quasi-regulation such as rulings, guidance notes and standards.

The Handbook provides that the level of regulatory impact analysis required is greater the more significant the regulatory proposal is likely to be. A preliminary assessment must be undertaken for all regulatory proposals. Proposals likely to involve medium business compliance costs must also have a further full quantitative assessment of compliance cost implications using the business cost calculator or approved equivalent. Proposals likely to have a significant impact require even greater analysis, including compliance cost quantification, to be undertaken and documented in a regulation impact statement (RIS).

The OBPR has responsibility for assessing the adequacy of RISs. Proposals should generally not proceed to the decision-making stage until the OBPR has advised that, where further analysis was required, an appropriate level of analysis has been undertaken (unless exempted from these requirements by the Prime Minister of the day).

Where proposals proceed without an appropriate level of analysis, the resulting regulation must be subject to a post-implementation review, to be commenced within 1 to 2 years of the regulation's introduction. The OBPR is required to assess post-implementation reviews.

In presenting the proposals to Parliament, the then Minister for Finance and Deregulation stated that in performing its role, the OBPR is concerned only with the standard of analysis undertaken. It does not endorse or support particular regulatory options or outcomes. Such deregulation policy matters will be dealt with in the Deregulation Policy Division as part of the government's broader better regulation agenda. The OBPR's independence is given effect through procedures which provide that neither ministers nor their staff can seek to intervene in or influence the OBPR's deliberations. Decisions on the adequacy of a RIS and compliance with the best practice regulation requirements will be made independently by the Executive Director of the OBPR.

The OBPR prepares an annual *Best practice regulation report* which reports on compliance with the best practice regulation principles on an agency by agency basis, and its public release is seen as an important element in ensuring transparent and accountable regulation making.

### 5.1.3 UK

In the UK, the organisation charged with promoting regulatory quality, or "better regulation" is the Better Regulation Executive (BRE), which is now part of the Department of Enterprise, Business and Regulatory Reform. The Government has issued its five principles of better regulation, which are that any regulation should be:

- transparent
- accountable
- proportionate
- consistent
- targeted – only at cases where action is needed

The BRE issues codes of practice, for example on issuing guidance, and on inspections and enforcement. It develops the "pro forma" regulatory impact assessment form that Departments are required to complete. Departments are encouraged to consult with the BRE in formulating rules, policies and guidance, but there is no formal approval process.

### 5.1.4 Canada

The Canadian Government adopted the Cabinet Directive on Streamlining Regulation in April 2007, which is administered by the Regulatory Affairs division. Its principles of "good regulation" are that when regulating, the federal government will:

- "Protect and advance the public interest in health, safety and security, the quality of the environment, and the social and economic well-being of Canadians, as expressed by Parliament in legislation;
- Promote a fair and competitive market economy that encourages entrepreneurship, investment, and innovation;
- Make decisions based on evidence and the best available knowledge and science in Canada and worldwide, while recognizing that the application of precaution may be necessary when there is an absence of full scientific certainty and a risk of serious or irreversible harm;

- Create accessible, understandable, and responsive regulation through inclusiveness, transparency, accountability, and public scrutiny;
- Advance the efficiency and effectiveness of regulation by ascertaining that the benefits of regulation justify the costs, by focussing human and financial resources where they can do the most good, and by demonstrating tangible results for Canadians; and
- Require timeliness, policy coherence, and minimal duplication throughout the regulatory process by consulting, co-ordinating, and co-operating across the federal government, with other governments in Canada and abroad, and with businesses and Canadians.”

The Directive provides guidance on the identification and selection of objectives, consultation, assessment of regulatory responses, instrument mixing, cost-benefit analysis, co-ordination, planning for implementation, monitoring and enforcement, and measuring, evaluating and reviewing regulation. It is supported by a range of legal requirements and best practice documents on issues which include effective use of scientific and technology advice, the precautionary principle, rule making and environmental assessments.<sup>43</sup>

## **5.2 Regulatory Quality (i) ex ante and ex post regulatory impact assessments including burden reduction evaluations**

### **5.2.1 Regulatory impact assessments / cost-benefit analysis**

Requirements to conduct some form of cost-benefit analysis or regulatory impact assessment may come from one or more sources: “whole-of-government” legislation, “whole-of-government” requirements emanating from the executive, regulator-specific legislative requirements, and self-generated regulatory initiatives.

A number of the regulatory agencies have specific statutory obligations to conduct some form of regulatory impact or cost benefit analysis of their proposed rules and / or guidance. The FSA is under a statutory duty to undertake a cost benefit analysis of all proposed rules and guidance, and to demonstrate that these will further its objectives. The OSC is required to undertake cost benefit analysis of all proposals. CFTC is under the same obligation, and to an extent, is the SEC. OSFI does not have to undertake a regulatory impact analysis process, however, though is subject to “whole-of-government” guidance on “streamlining” regulation, which includes a provision to perform cost-benefit analysis. In Australia, ASIC and APRA are subject to “whole-of-government” processes overseen by the OBPR which require a regulation impact statement or assessment of compliance costs for all regulatory proposals which are likely to have significant impacts on business and individuals or impose “medium” compliance costs on business (respectively).

In France, there is no specific requirement on the AMF to conduct any cost benefit analysis or regulatory impact assessment prior to issuing a new rule. However the AMF, with the regulators of other member states, assists the EU Commission and CESR in the procedures they adopt in this regard.

#### **5.2.1.1 Whole-of-government provisions on RIAs**

“Whole-of-government” processes and institutions were described in the preceding section. In Canada the Treasury Board of Canada Secretariat reviews the RIA statement of all regulatory proposals. In the US there has been until January 2009 a centralised process of notification and review for executive agencies including the OCC, but not for the independent regulators (including FR, SEC and CFTC). In contrast, regulators in Australia have since late 2006 been required to have their RIAs approved by a whole-of-government better regulation unit (the OBPR). There is no whole-of-government process for RIAs in France to which the AMF is subject.

Australia has a three tiered system to assess all regulatory and quasi-regulatory proposals. All regulatory proposals have to undergo a preliminary assessment to determine whether they are likely to involve an impact on business, individuals or the economy. If the impact is likely to be greater than minimal, then the regulator is required to consult with the OBPR to determine the appropriate level of regulatory analysis. A Business Cost Calculator (BCC) report is required where the preliminary assessment shows that the proposal potentially involves “medium” compliance costs. A Regulation Impact Statement (RIS) is required where the preliminary assessment shows that the proposal is likely to have a significant impact (whether in the form of compliance costs or other impacts), or restrict competition.

One of the common dangers of RIAs is that they are undertaken once the policy has been decided upon (see *e.g.* Raedelli and de Francesco, 2007). In order to try to avoid this, the Australian Government has decided that the RIS or BCC report must be prepared by officials once an administrative decision is made that regulation may be necessary, but *before* a policy decision is made by the Government or its delegated officials that regulation is necessary.<sup>44</sup>

In Canada there is “whole-of-government” guidance on RIAs which applies to OSFI. While OSFI is not under a formal statutory obligation to produce CBAs or the equivalent, the obligation to produce CBAs comes from a Cabinet Directive, which is nevertheless strong. This Canadian Cabinet’s Directive on Streamlining Regulation, applies to all federal regulatory agencies and departments including OSFI. This provides that, in consultation with Regulatory Affairs, departments and agencies will assess regulatory proposals at an early stage to determine where approval processes can be streamlined and where resources should be focussed.

Factors to be considered include the potential impact of the regulation on: health and safety, security, the environment, and the social and economic well-being of Canadians; on the Canadian economy and its international competitiveness; on other government bodies; and the degree of interest and support amongst affected parties. Agencies are required to identify and assess public policy issues, including independent risk assessments where appropriate; set measurable objectives that address the policy issue and its causes and develop and deploy relevant performance indicators, select the appropriate mix of government instruments, assess legal implications, and cross-national and international co-ordination issues; develop implementation, compliance and enforcement strategies; and conduct and publish evaluations of regulatory performance

#### 5.2.1.2 Statutory obligations to perform RIAs

Regulatory agencies may be under specific legislative requirements to conduct RIAs and CBAs under the statutes which establish them and / or from which they derive their powers. As noted, the AMF is under no such obligation. In contrast, the FSA, OSC, CFTC, and to an extent, the SEC are under a statutory obligation to conduct a form of CBA. In these countries, specific legislative provisions are applicable directly to the relevant agencies.

The FSA is under a statutory requirement that all proposed rules and guidance must be accompanied by a cost benefit analysis, an explanation of the purpose of the proposed rule, a statement of compatibility of the rule with the FSA’s objectives. A government review of the FSA in 2002, two years after it commenced operations under the new legislation, recommended the establishment of a specific department, the Economics of Financial Regulation Department, to develop methodology for performing cost-benefit analyses.



The FSA has formulated a code of practice, A Guide to Market Failure Analysis and High Level Cost Benefit Analysis (FSA, 2006), which has been extensively revised over time, which all policy makers are expected to follow when considering policies which are likely to have material market-wide impacts. This includes, but is not limited to, the promulgating rules and guidance, and in addition goes beyond the statutory requirements in considering a wide range of costs and benefits, and not just those relating to the attainment of its objectives.<sup>45</sup> The guidance makes it clear that although market failure analyses must be conducted, markets are always imperfect to some degree; what is relevant is whether markets are imperfect in such a way as imperils the FSA's statutory objectives. However, it may also be that regulation is justified to achieve those objectives even where there is no market failure, and moreover that "welfare weights" should be applied where the FSA's objectives require the favouring of one group over another. It is important to note that the Guide stipulates that market failure analyses (MFAs) and cost-benefit analyses (CBAs) do not need to be performed when the FSA is implementing an EU Directive, unless it is imposing "super-equivalent" requirements, as the FSA has no choice but to implement these provisions, whether they would "pass" an MFA and CBA or not. However, policy makers within FSA are urged to use MFA and CBA in policy negotiations at the EU level on proposed Directives.

The Guide provides that the MFA and the high level CBA should deal with six questions (para 10)

- **MFA:**

- A. What is the relevant economic market or markets?
- B. What are the material market failures and/or regulatory failures<sup>46</sup> in the relevant market(s) now?
- C. If no intervention or no further intervention takes place, will an improvement in welfare take place? Will the market failures be corrected in the short term?

- **High level CBA:**

- D. What broadly are the regulatory options for the FSA?
- E. What are the economic and other costs and benefits of the options, relative to doing nothing?
- F. What is the plan for further CBA work?

An MFA and high level CBA have to accompany any policy proposal being put forward to the Regulatory Policy Committee. To facilitate the linking of the FSA's objectives to market failure analysis, the Guide "re-describes" these objectives in terms of the market failures which may mean the objective may not be achieved. For example, the consumer protection objective is defined in terms of market failures of information asymmetry, negative externalities and market power. Economic impacts are to be assessed in terms of their impacts on firms and consumers and their respective behaviour, and on the nature of transactions carried out in the markets, as well as on competition.

The FSA also has more detailed guidance on performing cost benefit analysis, which has been externally reviewed by an economic consultancy firm (FSA 2006b). In performing a high level cost benefit analysis, central government guidance is incorporated into the Guide for calculating the costs of compliance including "administrative burdens" (Better Regulation Executive, 2005). There is recognition of the difficulties in assessing benefits, and the FSA also adopts an approach of assessing consumer detriment in the market, in conjunction with external consultants (see *e.g.* FSA 2008b). There is a particular emphasis on the manner and extent to which the proposed policy is likely to have the desired impact on the behaviour of both firms and consumers. In particular it notes that "[j]ust as in a more rules-based regime, CBA in a more principles-based regime needs to be based on explicit assumptions about supervision and enforcement, as these provide firms with the incentive to comply" (Para 79). The Guide also provides a sample MFA and CBA for policy makers for illustration. The CBAs for policy proposals and final decisions are published.

In Canada, the OSC is under a statutory obligation to take into account the economic impact of regulations before their adoption. The recent FSAP on Canada noted that the OSC has made significant progress in this area, through the creation of the Economic Analysis, Strategy and Project Branch whose function is to prepare a cost-benefit analysis for significant policy projects, for example, on auditor oversight, certification of disclosure in issuers' annual and interim filings; and mutual fund governance (IMF 2006b). In 2006-07, the OSC completed cost-benefit analyses on proposed rule changes to the national instrument (*i.e.* rule issued by the CSA and adopted by the provincial securities commissions) relating to the use of client brokerage commissions as payment for order execution services or research and amendments to provisions on disclosure of executive compensation (OSC, 2008). These are published on the OSC website.

In the US, the SEC is required to consider or determine whether an action is necessary or appropriate in the public interest, and in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.<sup>47</sup> The SEC is also required to consider the impact a rule would have on competition and prohibits the adoption of any rule that imposes a burden on competition not necessary or appropriate.<sup>48</sup> As noted above, the SEC is required with respect to "major rules" to notify the GAO and Congress of the rule including a cost-benefit analysis. The SEC has been criticised for the inadequacy of its cost benefit analyses on occasion, however, notably with respect to proposed rule changes regarding mutual funds. Two Commissioners took the unusual step of publicly criticizing the cost-benefit analysis that had been performed, and the rules were overturned on judicial review, as the court found that the cost-benefit analysis had been insufficient (Ershwin, 2005).

The CFTC is required by statute to consider costs and benefits of its action before issuing a new regulation.<sup>49</sup> This does not require quantification the costs and benefits of new regulation, but does require the CFTC to evaluate its proposals according to five areas of market and public concern:

1. Protection of market participants and the public
2. Efficiency, Competitiveness, and Financial Integrity of futures markets
3. Price discovery
4. Sound risk management practices
5. Other public interest considerations

The CFTC has discretion over weight distribution on any of the five areas, and has discretion to determine that a particular regulation was necessary or appropriate to protect the public interest or to effectuate any of the provisions or to accomplish any of the purposes under the CFTC Act.

The OCC does conduct regulatory impact analyses, and conducted one of the US's adoption of the Basel II Accord, for example (OCC, 2006). This RIA was incorporated into the joint notice of rule making issued by the four main banking regulators, the FDIC, OTS, FR and the OCC (OCC, 2006).

#### 5.2.1.3 Burden reduction

The UK and Australia have both been developing whole-of-government initiatives on burden reduction, and have adopted a "one-in-one-out" principle. In Australia, Ministers are required when bringing forward new regulatory proposals to demonstrate they have looked for regulatory offsets, such as other areas where regulation can be modified or removed to reduce compliance costs for business, thereby addressing the cumulative burden of regulation. In Canada, the Paper burden Reduction Initiative is designed from a whole-of-government perspective ([www.reducingpaperburden.gc.ca](http://www.reducingpaperburden.gc.ca)).

In the UK similar principles have been introduced. Although the FSA retains autonomy in policy formation, it has gone through its own “burden reducing” exercises, for example eliminating many of the rules on money laundering from its Handbook which largely duplicated provisions found in delegated legislation or industry codes, and streamlining the procedures for notifying changes in approved office holders in the “approved persons” regime.

#### 5.2.1.4 *Ex post* review

Again, provisions for *ex post* implementation reviews can come from a number of sources, and be applicable either across the whole-of-government, and / or be specific to the regulatory agency concerned.

Each agency publishes an annual report which reviews aspects of its work and performance in the previous year. Typically these also include quantitative indicators of inputs and the more straightforward outputs, such as numbers of approvals given and time taken, numbers of inspections done and enforcement actions taken, staffing levels and resources.

More in depth reviews which focus on outcomes are harder to perform, and many of the regulators are looking for better ways in which to assess their performance than the standard input and output metrics. In each of Australia, Canada, the US and the UK, the national audit bodies perform periodic reviews of regulators’ performance which are not limited to their financial management and which attempt to evaluate the broader impacts of the regulators’ performance.

In the UK, the NAO can review the FSA at the request of the executive, although the FSA is not within the remit of the National Audit Office (NAO) which means that the NAO cannot review the FSA of its own accord. The NAO has been asked by the Treasury on two occasions to review the performance of the FSA in particular respects (NAO, 2006, 2008). In Canada, the Auditor-General has issued reports on OSFI, though the most recent was 2000 (Auditor General, 2000).

In Australia, the Australian National Audit Office has reviewed the performance of APRA and ASIC (Auditor General, 2005, 2006, 2007). There is also an expectation that any measure introduced which did not go through the *ex ante* RIA process will be reviewed; for example the introduction of the short selling restrictions obtained a Prime Ministerial exemption from the OPBR review process, but have to be reviewed within two years of their adoption (assuming they are still in effect).

In the US, the GAO has issued reports on aspects of the operation of each of the FR, OCC, SEC and CFTC, as well as a number of reports critiquing the structure and operation of the system of financial regulation as a whole. Most recently it published a framework for developing and assessing proposals to reform the US financial regulatory system, which it has persistently analysed as being in need of reform (GAO, 2009).

Finally, in the US, as noted, the Congressional Review Act allows Congress to review every new federal regulation issued by the government agencies and, by passage of a joint resolution, overrule a regulation. GAO’S primary role in this mechanism is to provide the Congress with a quick review of all ‘major’ rules submitted to determine if the promulgating agencies have complied with the procedural steps governing the regulatory process. In addition, the GAO periodically conducts studies or investigations of regulatory programmes.

Within the SEC and the CFTC, the agency's Office of the Chief Economist also conducts *ex post* review of measures of effectiveness on implemented regulations. Within the CFTC, the Office of the Inspector General also evaluates the administration of the Agency, including audits of compliance with Federal laws, such as the Government Performance and Results Act (GPRA) of 1993. It also investigates programs and operations of the CFTC and recommends policies to promote economy, efficiency, and effectiveness in CFTC programs and operations and to prevent fraud and abuse.

### 5.3 **Regulatory Quality (ii) Transparency and communication**

Transparency is a frequent requirement of "quality" regulation. The 2005 OECD Guiding Principles require regulation to be transparent, and the country specific reports that the OECD has conducted on regulatory quality assess transparency and communication of their regulatory agencies.

Heald provides a useful framework for analyzing the nature of transparency (Heald, 2006). His framework analyses transparency with respect to its direction, and with respect to its nature, which he analyses in terms of three dichotomies. In terms of direction, transparency can be upwards to political principals; downwards to the "ruled"; outwards, in the sense that the regulator can "see" what is happening in the external environment (*e.g.* "market transparency"), and inwards, where those outside can observe what is going on inside the organisation, *e.g.* through freedom of information legislation). In "better regulation" terms, the transparency being referred to is usually upwards, downwards and inwards, rather than being outwards.

The three dichotomies are event / process transparency; transparency in retrospect / transparency in real time; and nominal / effective transparency. Event transparency is transparency with respect to things which are relatively visible and measurable, *i.e.* inputs, outputs, and to an extent, outcomes; processes are those linkages between them, which are frequently poorly understood. Transparency with respect to processes, particularly operational processes (as opposed to procedural rules) is usually difficult, and he argues, can be dysfunctional to the achievement of policy objectives. Heald's model is built with public service delivery in mind, but in the regulatory context, one could see consultation processes as being "process" transparency; similarly the publication of risk-based frameworks of supervision. The second dichotomy is transparency in real time versus post hoc transparency. Real time transparency is hard to achieve, and he argues, probably undesirable, whereas post hoc transparency allows the organisation to conduct its business and then report (though obviously gives rise to issues of validation). This leads us to the third dichotomy, nominal versus effective transparency. There can be a gap between nominal and effective transparency; what Heald calls the "transparency illusion". He uses the example of off-balance sheet accounting in public sector accounts; but as the financial crisis has reveals, the "transparency illusion" has arisen for the same reason with respect to banks' financial positions, though in Heald's terms this particular "transparency illusion" has damaged the regulators' "outward" transparency (*i.e.*, its ability to see), rather than its "upwards" or "downwards" transparency.

Regulatory transparency tends to relate to both events and processes, to be in "real time" in so far as it relates to current policy proposals or practices, and "*post hoc*" through various reporting requirements. It also can be "*ex ante*" in so far as regulators publish their strategic plans for the future. Whether it is nominal or effective is a question that cannot be answered in the abstract, however.

The regulators engage in structured consultation processes before issuing any regulatory requirement, publishing consultation papers, allowing specified times for comment, responding to comments, and finally publishing the final requirements. In some cases these consultation procedures are set out in the individual statutes of the regulatory bodies (*e.g.* FSA).

In France, all the financial regulators are subject to the same set of legislative requirements on consultation, introduced in the reforms of 2004. Two specified and different forms of consultation are mandated. First, the Consultative Committee for the Financial Sector (*Comité Consultatif du Secteur Financier* CCSF), is composed of representatives of financial professionals representing each of the sectors including insurance agents and their clients. The committee has to be consulted on issues concerning relations between the financial sector and its clients. Second, the Consultative Committee for Financial Legislation and Regulation (*Comité Consultatif de la Législation et de la Règlementation Financières*, CCLRF) which has to be consulted on all legislation and rules except for those within sole competence of the AMF (L.621-7V), prior to approval by the Ministry. Membership for these bodies is required for each financial services provider. Each investment services provider and market also must adhere to an association of its choice charged with representing the collective rights and interests of members (L.531-8). This organisation will be affiliated with the *Association Française des Etablissements de Crédit et des Entreprises d'Investissement* (L.511-29), which is the related association for credit institutions (IMF, 2005, Para 100). In addition, the AMF typically establishes working groups and conducts *ad hoc* market consultations (*consultations de place*).

There may also, or alternatively, be “whole-of-government” provisions on consultation which apply. In the US, rule making processes of the federal agencies are governed by the Administrative Procedure Act and the Freedom of Information Act (Sunshine in Government Act) which require notice of all proposed rules and the provision of opportunity to comment. Australia has also recently introduced a legislative requirement for consultation prior to the formulation of regulatory provisions, and the explanatory memorandum to any legislative proposal has to state what consultation processes were have been followed (Legislative Instruments Act).

In the US, UK, Canada and Australia there is “whole-of-government” guidance which sets out principles of consultation which apply to the regulatory agencies. In Australia, for example, these require:<sup>50</sup>

- Continuity – consultation should be a continuous process that starts early in the policy development process.
- Targeting – consultation should be widely based to ensure it captures the diversity of stakeholders affected by the proposed changes. This includes State, Territory and local governments, as appropriate, and relevant Commonwealth departments and agencies
- Appropriate timeliness – consultation should start when policy objectives and options are being identified. Throughout the consultation process stakeholders should be given sufficient time to provide considered responses.
- Accessibility – stakeholder groups should be informed of proposed consultation, and be provided with information about proposals, via a range of means appropriate to those groups.
- Transparency – policy agencies need to explain clearly the objectives of the consultation process, the regulation policy framework within which consultations will take place and provide feedback on how they have taken consultation responses into consideration.
- Consistency and flexibility – consistent consultation procedures can make it easier for stakeholders to participate. However, this must be balanced with the need for consultation arrangements to be designed to suit the circumstances of the particular proposal under consideration.
- Evaluation and review – policy agencies should evaluate consultation processes and continue to examine ways of making them more effective.

In Canada, the Directive on Streamlining Regulation requires agencies, when undertaking consultations, to: inform and engage Canadians on the nature and implications of the public policy issue based on available evidence, science, or knowledge; include Canadians in developing policy objectives; set out the process and timelines in a clear manner so that affected parties can organise and provide input; and provide timely feedback to Canadians and affected parties on the outcome of the consultations and on the priorities considered in decision making. Departments and agencies are to publish proposals in the *Canada Gazette*, Part I, to allow for a public comment period and to then take the comments received into consideration. The standard comment period is 30 days, but it can vary based on legislative requirements, international obligations, and other considerations. A minimum comment period of 75 days is required for proposals for new and changed technical regulations that may affect international trade.

In addition to these consultation processes which relate to specific regulatory changes, many regulators also have frameworks in place for continual consultation with stakeholders. For example, ASIC holds advisory “forums” at specified intervals throughout the year. These are advisory groups with identified members, and they include an accounting liaison group, “big four” technical accounting partners, business advisory committee, business consultative panel, Consumer Advisory Panel forum and a “Regional Liaison Committee” forum. The SEC has advisory panels

Most regulators have established ways of communicating with regulated firms. This can include specific investment advisory committees, such as those constituted by the OSC and the AMF. Structured and proactive measures for communicating with consumers (other than through investor education initiatives) are more sporadic, as discussed above (accountability to stakeholders). The FSA, the AMF and ASIC have an organised body, which represents consumer interest but the others do not.

Some regulators also publish newsletters or updates. OSFI’s external newsletter, *The Pillar*, introduced in 2006-2007, was published three times in 2007-2008. It serves to remind key stakeholders of the latest guidelines, notices, public statements, and other pertinent information released by the Office. The FSA publishes “market watch” which updates firms on interpretations of the Code of Conduct on Market Abuse on recent FSA enforcement decisions in the area.

Most also pay attention to their websites, and indeed ASIC was required to enhance its website in the Banks review. In Canada, OSFI’s external web site was changed so that it will comply with the Government of Canada’s new Common Look and Feel Standards for the Internet 2.0.

#### **5.4 Regulatory Quality (iii) Co-ordination mechanisms**

The OECD RQP Principles on co-ordination focus specifically on co-ordination with competition law, requiring that governments ensure that regulation is consistent with other policies which ensure competition and liberalisation, and more broadly with policies in other areas such as the environment. At the international level, they require that regulation is consistent with international principles on trade, competition and investment.

While they underline the need for policy coherence and for a whole-of-government perspective, the OECD RQP Principles do not focus on the need for co-ordination between different regulatory bodies which are operating within the same broad domain or sector. Regulatory functions are often divided between a number of regulatory bodies within a single domain, however, and not only in financial services: food safety, the environment, occupational health and safety are all characterised by the distribution of regulatory responsibilities across a number of bodies within countries, and moreover between regulators operating at different levels: provincial, national, supra-national and transnational. One of the critical issues in the performance of a regulatory regime, therefore, is co-ordination between the different regulators who are involved in its performance. This issue has been analysed in depth in specific OECD reviews of regulatory authorities in given countries (OECD, 2004, 2006, 2008).

This sub-section therefore departs to an extent from the country-specific evaluations of quality regulation in that it examines the co-ordination structures which operate within a particular sector, here financial regulation, and moreover its focus is on co-ordination at the EU and transnational level as well as the national level.

#### 5.4.1 *Australia*

The Council of Financial Regulators is the co-ordinating body for Australia's main financial regulatory agencies. In addition, there are bilateral MOUs between each of the members. In September 2008, the Council published an MOU between the Council members. The MOU sets out the objectives, principles and processes for dealing with stresses in the Australian financial system. The MOU identifies the responsibilities of each Council member and is intended to facilitate a co-ordinated response to stresses in the financial system.

The Council is non-statutory and has no regulatory functions separate from those of its members. Its membership is comprised of the Reserve Bank of Australia, which chairs the Council; the Australian Prudential Regulation Authority (APRA); the Australian Securities and Investments Commission (ASIC); and the Australian Treasury.<sup>51</sup>

The Council's Charter, agreed in 2004, stipulates that the aims of the Council are to facilitate co-operation and collaboration between the financial regulators. Its objective is to contribute to the efficiency and effectiveness of financial regulation and to promote stability of the Australian financial system by providing a high-level forum for co-operation and collaboration among its members. The Council is charged with:

- Identifying important issues and trends in the financial system, including those that may impinge upon overall financial stability;
- Ensuring the existence of appropriate co-ordination arrangements for responding to actual or potential instances of financial instability, and helping to resolve any issues where members' responsibilities overlap; and
- Harmonising regulatory and reporting requirements, paying close attention to the need to keep regulatory costs to a minimum.

It operates as an informal body in which members are able to share information and views, discuss regulatory reforms or issues where responsibilities overlap and, if the need arises, co-ordinate responses to potential threats to financial stability. The Council also has a role in advising the Government on the adequacy of Australia's financial system architecture in light of ongoing developments, and in 2005 issued a report on responding to financial crises.

#### 5.4.2 Canada

The principal co-ordination structure for financial stability and banking supervision in Canada is the Financial Institutions Supervisory Committee (FISC). This meets at least quarterly to facilitate the exchange of information among OSFI, the Department of Finance, Bank of Canada, Canada Deposit Insurance Corporation (CDIC), and the Financial Consumer Agency of Canada (FCAC) on matters relating to the supervision of financial institutions.

Co-ordination between the securities regulators is facilitated by the Canadian Securities Administrators (CSA). This was given a more formal institutional structure in 2003, and it has enhanced co-ordination between the securities commissions in a number of respects, although the FSAP review noted that this was still not at an optimal level (IMF 2008b). Most notable of the initiatives to increase co-ordination relate to rule making, the introduction of a “passporting” system, and the development of common platforms for firms to file regulatory returns. With respect to policy and rule making, the securities commissions have developed a number of “national policies” and “national instruments”, which are common rules covering key areas such as prospectus requirements, mutual fund regulation, rights offerings, take-over bids, registration issues and marketplace operations. They are also acting in collaboration with the pensions and insurance regulators to introduce common rules on point of sale disclosures. Co-ordination has also been enhanced through the introduction in 2004 of a “passporting system” whereby firms authorised by one securities regulator may operate in other provinces and territories, with the important exception of Ontario. With respect to Ontario the passporting system operates asymmetrically, in that the Ontario Securities Commission (OSC) requires firms to be separately authorised by the OSC if they want to operate in Ontario, but the other securities commissions will accept OSC authorisation as sufficient to passport firms into their own jurisdiction (CSA, 2004). The commissions also operate the “mutual reliance review system” (MRSS) in which one commission is designated as the principal regulator for an authorised entity and others agree to rely on its findings with respect to that institution, though any individual commission may opt out and choose to undertake its own investigations at any time.

#### 5.4.3 France

France has a complex institutional structure for financial regulation, particularly with respect to banking and prudential supervision. Co-ordination between the AMF and the prudential authorities in day to day matters is organised through inter-staff contacts, information sharing, certain combined databases, and regular monthly meetings. In the case of general policy and matters of particular cross-market or common interest, co-ordination is accomplished through an inter-institutional, statutorily-prescribed board composed of the heads of the financial services agencies (the *Collège des autorités de contrôle des entreprises du secteur financier*). It is presided over by the Minister of Finance or his representative, and must meet at least three times a year (IMF, 2005). The Chairs of the CB, AMF and the CCAMIP are members and the *Collège* provides a forum to exchange information on cross-sector issues, prepare regulatory proposals to improve cross-sector supervision, and facilitate exchange of staff to enhance a cross-sector approach to financial sector supervision (COMOFI Art. L.631-2).

In addition, there is cross membership of the regulatory and supervisory authorities to facilitate co-operation. For example, the AMF chair is a participant on the Board of the CECEI, and the Governor of the Banque de France is a member of the AMF Board (IMF, 2005, Para 98).



#### 5.4.4 UK

Co-ordination of the Treasury, the Bank of England and the FSA in financial supervision is embodied in formal terms in the Tripartite Agreement, an MOU agreed between the parties, which sets out their respective roles (FSA). There has been considerable criticism of the way that this co-ordination has operated, and new legislation has been introduced to assign specific roles to each body with respect to the management of failing banks and systemic support during a crisis.<sup>52</sup> However, the Tripartite Agreement has not yet been revised.

The agreement stipulates that the responsibility of the Bank of England is to administer monetary policy, oversee the payments system, to advise on the implications for UK financial stability of developments in the domestic and international markets and payments systems, assesses the impact on monetary conditions of events in the financial sector, and in exceptional circumstances, such as those which have in fact prevailed for the last 18 months, to undertake official financial operations to maintain systemic stability. The role of the FSA is to fulfil the role and objectives set out in the Financial Services and Markets Act 2000, viz to protect consumers, to maintain market confidence, to reduce the scope for financial crime and to promote public understanding. Specifically, it is responsible for the micro-prudential regulation of banks. The Treasury has no operational responsibilities; rather its role is for the overall institutional structure, EC negotiations, and accounting to Parliament for the management of serious problems in the financial system.

Operationally, co-ordination occurred through the Standing Committee on Financial Stability, which was meant to meet monthly at a deputies (officials) level. There is brief provision for the handling of a financial crisis, which emphasises co-ordination and information sharing. Far more specific procedures for managing failing banks with much clearer delineations of responsibility are now contained in the Banking Act 2009.

#### 5.4.5 US

The fragmented structure of US financial regulation means that there is a significant need for co-ordination between both the functional regulators, and with respect to banks, between state and federal regulators.

The regulators have bilateral co-ordination arrangements between themselves, for example between the CFTC and SEC, and the Federal Reserve and the SEC. With respect to deposit taking institutions, the Federal Financial Institutions Examination Council (“FFIEC”), established in 1978, co-ordinates principles and standards for the examination and supervision of depository institutions. It is comprised of the OCC, the Federal Reserve, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, the National Credit Union Administration, and the Conference of State Bank Supervisors. States participate in the FFIEC through a five member Liaison Committee. The FFIEC’s purposes are to prescribe uniform federal principles and standards for the examination of depository institutions, to promote co-ordination of bank supervision among the federal agencies that regulate financial institutions, and to encourage better co-ordination of federal and state regulatory activities.

The principal co-ordinating body for all the main financial regulators is the President’s Working Group on Financial Markets, chaired by the Secretary to the Treasury. The group comprises the Federal Reserve, the SEC, the CFTC and the Treasury. The Working Group reports to the President “its views on any recommended legislative changes.”<sup>53</sup> It can also raise objections and block rule-making by any of the agencies through informal processes.

A significant example is the Group's blocking of CFTC proposals to regulate the over-the-counter (OTC) derivatives markets in 1997-9. In 1998 the CFTC had issued a policy proposal (concept release) on the regulation of the OTC derivatives markets. However, the chairs of the other regulators called on Congress to prevent the CFTC from acting until they had developed their own recommendations. In September 1998 Congress issued a legislative moratorium preventing the CFTC from taking additional regulatory action in the area of OTC derivatives for six months. In the interim, Long-Term Capital Management collapsed. The President's Working Group's report, issued in April 1999, concluded however that only one legislative change was required as a result, which was that brokerages' unregulated affiliates be required to assess and report their financial risk to the government. In June 1999, the CFTC chairman, Brooksley Born, resigned. In November 1999, the Group delivered a study of the OTC derivatives markets and to develop legislative recommendations for Congress. The Commodity and Futures Modernization Act 2000 accordingly specifically exempted OTC derivatives from oversight by the CFTC.

#### 5.4.6 EU

At the EU level, the Lamfalussy reforms introduced a four tier system of rule formation and implementation. At the first level, the EU institutions formulate directives which are meant to operate at the level of principle, though can in practice be quite detailed. Those first level directives specify which provisions should be the subject of level 2 measures. Level 2 measures provide more detail with respect to certain provisions. These can take the form either of Directives or Regulations. At Level 3, the three Committees of sectoral regulators have the role of providing guidance to member states' regulators on implementation and supervisory practices. These are CESR (securities), CEBS (banking) and CEIOPS (insurance). At Level 4 are the member states.

In March 2009, following the crisis, the de Larosiere report recommended significant changes to the structure of financial regulation in the EU, as well as more specific technical changes (de Larosiere, 2009). With regards to regulatory structures, the High Level Group considered a new body called the European Systemic Risk Council should be set up under the auspices of the European Central Bank (ECB) and chaired by the President of the ECB. It would be composed of the members of the General Council of the ECB, the Commission plus the Chairs of the three Level 3 committees, CEBS, CEIOPS and CESR. Insurance and securities supervisors will be brought in where necessary. Its role will be to gather information on all macroprudential risks in the EU. In order to perform this function it should have access to all necessary macro and micro information and issue risk warnings on which there would be mandatory follow-up and monitoring by EU supervisors. If the risks were very serious they should be taken up by the EFC, working with the Commission, to address the risks. At the global level, the ESRC should work closely with the IMF, FSF and the G20.

The second structural element relates to covers micro-prudential supervision (the supervision of firms). The proposal is for the establishment of a new European System of Financial Supervision (ESFS). In this system, the 3L3 Committees (CEBS, CEIOPS, CESR) would be each transformed into three new European Authorities (the European Banking Authority; the European Securities Authority; and the European Insurance Authority). These Authorities would have a considerably expanded role compared to the current Level 3 Committees including some legal powers. The main additional tasks of the Authorities on top of the competences of the existing Level 3 Committees, would be the following:

- legally binding mediation between national supervisors;
- adoption of binding supervisory standards;
- adoption of binding technical decisions applicable to individual institutions;

- oversight and co-ordination of colleges of supervisors;
- licensing and supervision of specific EU-wide institutions (*e.g.* Credit Rating Agencies and post trading infrastructures);
- binding co-operation with the ESRC to ensure adequate prudential supervision;
- strong co-ordinating role in crisis situations.

In its Communication to the Spring Council meeting on 18<sup>th</sup> and 19<sup>th</sup> March 2009 the Commission set out proposals for the reform of financial supervision at the EU level based on the De Larosière Report's recommendations.<sup>54</sup> These were confirmed by the Council in June 2009 and detailed legislative proposals made in September and October 2009.<sup>55</sup> Under these proposals the European Systemic Risk Board (ESRB) would be charged with developing a European macro-prudential perspective of systemic risk, enhancing the effectiveness of early warning systems, and allowing for risk assessments to be translated into action by the relevant authorities, who would be required to respond on a 'comply or explain' basis (European Commission 2009b). The Board would not have legal personality and its secretariat would be provided by the ECB. In addition, a European System of Financial Supervision is proposed, consisting of a network of national financial supervisors working in tandem with new European Supervisory Authorities (ESAs), created by transforming the existing European Level 3 committees into a European Banking Authority (EBA), a European Insurance and Occupational Pensions Authority (EIOPA), and a European Securities and Markets Authority (ESMA). The new authorities would have separate legal personality and act largely independently of the Commission. Their role will be to draft technical standards, with a view to the creation of a uniform European rule book. They will have powers to ensure the consistent application of Community rules. They will have a coordinative role, mediating disputes between national supervisors, and in an emergency requiring them to act in coordination. The Authorities are entitled to participate as observers in colleges of supervisors, and are expected to play an active role in the development of a common supervisory culture across EU member state supervisory bodies. It is also expected to work closely with the ESRB (EU Commission, 2009c).

#### 5.4.7 *International*

At the international level, co-ordination between the international groups of sectoral regulators currently occurs through the Financial Stability Forum (see Diagram 1 above). There are also specific co-ordination mechanisms which focus on specific issues: the Financial Action Task Force co-ordinates policies on money laundering, and the Joint Forum provides a forum for co-ordination on the supervision of financial conglomerates. The structure of international financial co-ordination is currently the subject of active political debate. In March 2009 the FSF announced that it was extending membership to the G20 countries. Proposals for further enhancement of international co-ordination include giving a more specific monitoring role to the IMF, and the establishment of "colleges of supervisors" for the supervision of systemically significant global financial conglomerates. The issue of the architecture of global financial regulation is part of the agenda for the G20 meeting in Spring 2009.

#### 5.5 *Regulatory Quality (iv) A dynamic approach to improving the regulatory system over time*

The 2005 OECD Guiding Principles require that regulation should be reviewed systematically. Regulation operates in a dynamic context, and can quickly become out of step with the industry or practices it is regulating. Ensuring that the regulatory system is dynamic is therefore essential. There are various means by which this can be achieved, including the reviews of regulatory effectiveness and implementation conducted by external bodies such as national audit offices, noted above, and reviews conducted by regulators themselves.

One of the most systematic, and structured, processes for review can be through the provision of “sunset” clauses. These provide that legislation will cease to have effect after a certain period of time unless it is renewed. There is always the danger that renewal becomes automatic, or is preceded only by a cursory assessment of impacts and operation. However, if sunset provisions prompt a thorough and objective assessment of the operation of the regulatory system, then they can be a way of facilitating the dynamic response of the regulatory regime to changes in market context and to its own operation.

Even if there are not sunset provisions, there can be requirements for periodic review of the regulatory regime. Canada is notable in this regard. Legislation applicable to federally regulated financial institutions is reviewed every five years to ensure it remains current and promotes an efficient, competitive and prudent financial services sector. This process has been described by the IMF as “unique”, and as significantly contributing to the reduction of regulatory impediments to competition and efficiency. The legislation was most recently renewed in 2007, and in each case adjustments have been made to streamline the regulatory requirements or render them more appropriate to a changing context.<sup>56</sup> In Canada, at a provision level, Ontario also requires legislation to be reviewed every five years. The last review of securities legislation occurred in 2003, but there has been no subsequent review despite the expiration of the deadline. Australia is also introducing five yearly reviews for all regulations not already subject to statutory review or sunset provisions. The first tranche of review will commence in 2012. In addition, class orders issued by ASIC are now subject to a 10 year sunset provision under the Legislative Instrument Act.

In the US, the banking regulators are subject to requirements to review their provisions, but the securities regulators are not. The OCC and the FR are subject to the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA). The Act requires the federal agencies that are members of the Federal Financial Institutions Examination Council (FFIEC) to review their rules every 10 years, to revise rules that are outdated, and to eliminate ones that are unnecessary.<sup>57</sup> The EGRPRA further requires the agencies to submit a report on the review’s findings to Congress. Accordingly, in 2007, the OCC reviewed its regulations. The Federal Reserve is also governed under EGRPRA and has done a phased review of some its rules both on a standalone and a joint inter-agency review with other banking regulators. It engages the main trade associations and other interest groups to give feedback on these proposed changes. However, the Act does not apply to the SEC and CFTC, which are not members of the FFIEC.

In France, there is no sunset general provision for financial legislation, nor is there in the UK. However, in the UK, exceptionally, the statute passed in 2008 to confer powers on the authorities to handle failing banks was time limited to one year. The Act was replaced and many of its elements carried over to the Banking Act 2009.

Part of being dynamic also requires the system, including the regulator, to be resilient. Again OSFI is notable here for undertaking its own resilience testing, in which it undertakes scenario analyses and stress testing of its own procedures to assess its ability to cope with stresses arising due to low probability but high impact events, such as a pandemic or terrorist attack. These include continued succession planning in all critical high-risk areas; updated emergency preparedness tools, facilities and processes to ensure effective recovery and continuity of critical services, planning for alternate resources to sustain critical services in the event of pandemic related staff shortages and introducing preventative measures to minimise potential impact on staff (OSFI, 2008).

There are also practices of setting up bespoke reviews of policy areas, both by the regulators themselves and by specially constituted groups or appointed individuals. In Australia, for example the Financial Services Working Group has been set up to address a particular policy concern, which is the complexity associated with financial services advice and disclosure.

Whether the group is external to the regulator or not often depends on the scope of the regulators' remit and powers. For example, a similar exercise to that of the Australian Financial Services Working Group is undertaken on an ongoing basis in the UK by the regulator itself, the FSA, because it has policy and rule making powers which ASIC does not. Nevertheless, the UK Treasury has initiated a succession of reviews of aspects of financial regulation even if these fall within the FSA's remit to some extent. Examples include the review of hedge funds by Sir David Walker, of access by consumers to low cost investment products by Sir Ron Sandler, and of private equity funds by Sir Andrew Large.

## **5.6 Regulatory Quality (v) Ethics codes, conflicts of interest policies and confidentiality provisions**

The 2005 *OECD Guiding Principles of Regulatory Quality and Performance* require that governments ensure that regulatory institutions include measures to ensure integrity (OECD, 2005, Recommendation 3). The Basle and IOSCO Principles contain a similar requirement. One way in which this can be achieved is through provisions on conflicts of interest.

The Canadian and Australian financial regulators are subject to detailed codes of conduct on conflicts of interest between their Boards and officials and the regulated industry. The three main areas that these provisions cover are investments, accepting gifts and hospitality, and obligations relating to confidentiality. OSFI and the US regulators also have "revolving door" provisions, that is provisions relating to employment after leaving the regulator.

Regarding conflicts of interest, OSFI has perhaps the strictest requirements. Legislation prohibits all board members and employees from holding securities or borrowing from any financial institution or institution which is substantially similar to a financial institution carrying on business in Canada, or securities in any corporation value the value of which is closely related to that of such a financial institution except in limited circumstances.<sup>58</sup> For Board members, holding securities in such a financial institutions is a ground for removal from office.

In addition, all board members and employees are under an obligation annually to make a confidential declaration on conflicts to the Superintendent (*e.g.* that their spouse is working in a financial institution). There is a statutory prohibition on any employee including Superintendent accepting gifts.<sup>59</sup> OSFI's guidelines on what this covers provide that it includes a prohibition on accepting hospitality to sporting events "because of the perceived conflict created when such types of hospitality that take place outside of the business environment are accepted".<sup>60</sup> Board members and employees are required to maintain confidentiality of information and are not allowed to use information gained in course of employment for personal gain, duties which continues post-employment. There is also a requirement that board members and employees have to wait one year after leaving OSFI before they can accept employment in an organisation with which they have had direct dealings as part of employment at OSFI, although the Superintendent can reduce the term. Breach of any of these provisions is a criminal offence.<sup>61</sup> The Superintendent is also required to comply with the Conflict of Interest and Post-Employment Code for Public Office Holders.

In Australia, APRA prohibits board members from being a director, officer or employee of a body regulated by APRA.<sup>62</sup> A person who is a director, officer or employee of a body operating in the financial sector, other than a body regulated by APRA, may be appointed as an APRA member, but only if the Minister considers that the person will not be prevented from the proper performance of the functions of the office because of resulting conflicts of interest.<sup>63</sup> Board members must disclose all conflicts of interest.<sup>64</sup>

The APRA *Code of Conduct* details the procedures for dealing with conflicts of interest amongst staff.<sup>65</sup> With regards to investments, on joining APRA, new staff with equity securities in APRA-regulated institutions (or close associates of regulated institutions) may retain them. However, they should not acquire additional such holdings, except as a direct consequence of demutualisations or the exercise of rights or pre-existing options. Staff are required to annually submit a summary statement of any direct security holdings, and those of their immediate family, which are reviewed by senior management. Staff can only make any new investments in APRA-regulated institutions (or close associates of regulated institutions) through managed funds. Where staff believe that they may have a conflict of interest between their obligations under the code of conduct and their investments, they must contact their manager immediately. Where a conflict arises or becomes apparent from the statement of holdings, their senior manager may either re-assign the staff member or request that they divest their holdings in the particular investment. Prior to selling any holding in excess of \$5,000, a staff member must consult their Executive General Manager or the Secretary of the Corporate Division. If the sale is judged likely to cause a problem or be perceived as causing a conflict of interest, the staff member may be requested not to proceed with the sale.

ASIC has less rigorous requirements both for board members (Commissioners) and for staff. That said, APRA regulates a far smaller number of institutions than ASIC, which is not just the financial regulator but the regulator of corporate governance for all companies in Australia, so a similar bar would have a more significant impact on a member's ability to manage their own financial affairs. There is no prohibition on members having a direct or indirect financial interest in a body corporate or business in Australia or any institution or product regulated by ASIC, these must just be disclosed to the Minister.<sup>66</sup> There is moreover no "revolving door" prohibition, though members have to disclose any agreements they have to enter into business relationships on leaving ASIC. Staff are under a statutory obligation to disclose conflicts of interest to the Chairperson,<sup>67</sup> and ASIC has elaborated these duties in a Code of Conduct.

The OSC has statutory obligations on employees relating to confidentiality of information gained on financial institutions, and it has its own code of ethics and professional conduct for its staff that deals with issues of honesty and integrity; procedural fairness; prevention of conflict of interest and confidentiality. Under the current framework staff can invest in securities; however specific conditions, restrictions and prohibitions do exist (for example staff are prohibited from carrying out transactions on securities that are being investigated; buying securities in margin; and short selling). There are reporting obligations regarding transactions in securities. Breach of the code may give rise to disciplinary proceedings.

In the UK, there are statutory requirements on confidentiality of information that apply to the FSA and its employees and office holders.<sup>68</sup> All board members are subject to the guidance and the Principles on Public Life, overseen by the Committee on Standards in Public Life. The seven principles are selflessness, integrity, objectivity, accountability, honesty, openness and leadership. The FSA has a Code of Conduct for staff which they are contractually obliged to follow. This requires full disclosure of all financial interests, restrictions on the use of confidential information, a requirement for any dealing in financial instruments to be authorised prior to occurring, and provisions on the receipt of gifts and hospitality. There is an Ethics Officer who is responsible for administering the Code.<sup>69</sup>

In the US, there are provisions relating both to "revolving door" and dealings in securities. With respect to the "revolving door", there are federal laws against former employees lobbying on behalf of clients. Federal prohibitions on lobbying by former employees include permanent restrictions on particular matters, two year restrictions on other specified matters, and specific restrictions on "very senior personnel".<sup>70</sup> In addition, federal banking regulators are subject to provisions which require that if an examiner serves as the senior examiner for a depository institution or depository institution holding company for two or more months during the examiner's final twelve months of employment with an agency or Reserve Bank, the examiner may not knowingly accept compensation as an employee, officer,

director, or consultant from that institution or holding company, or from certain related entities. The restriction applies for one year after leaving the employment of the agency or Reserve Bank. If an examiner violates the one-year restriction, the act requires the appropriate federal banking agency to seek an order of removal and industry-wide employment prohibition for up to five years, a civil money penalty of up to USD 250 000, or both (FRB, 2005).

The SEC has introduced rules which provide that persons who have been SEC employees within 2 years of employment termination are prohibited from appearing in a representative capacity before the SEC in any matter he or she participated personally and substantially while an employee, and are otherwise subject to a requirement to notify the Commission. Former employees in certain positions designated by the Director of Government Ethics are also prohibited from appearing in a representative capacity before the SEC or communicate with Commission or its employees with the intent to influence within one year of employment termination. The restrictions extend to partners and associates of the relevant person. Waivers may be granted by the SEC Office of General Counsel.<sup>71</sup>

With respect to dealings in securities, SEC employees may transact in securities only if they certify that they did not have insider information relating to the issuer, they do not deal on margin, and securities must generally be held for a minimum of six months.<sup>72</sup> Employees in the Investment Management Division and the Office of Compliance Inspections and Examinations are subject to more scrutiny in mutual fund investments, and funds must be diversified.

CFTC employees are prohibited from investing in commodity futures and derivative contracts unless through a publicly-available investment vehicle (such as a mutual fund or exchange traded fund).<sup>73</sup>

The Federal Reserve has layers of restriction of Bank Examiners and employees with knowledge of relevant regulatory and supervisory actions. It prohibits them from holding stock or debt securities of any bank, thrift, other depository institution, or their affiliates. (Source: FRB, Employee Code of Conduct). Finally, the U.S Department of Treasury's Standards of Ethical Conduct prohibits its employees or dependants from owning directly or indirectly, securities of any commercial bank (including both national and State-chartered banks) or commercial bank affiliate, including a bank holding company. They can invest in publicly traded mutual funds as long as the holding in banks is less than 25% of the total assets of the fund.<sup>74</sup>

Finally, in France, under the COMOFI (L.621-4), the members and the staff of the AMF as well as the experts appointed to any consultative commission are subject to professional secrecy requirements and subject to penal sanctions (L.642-1 and L.621-4 II) for their violation. In addition, the provisions on avoiding conflicts of interest require disclosure of interests to the Chairman of the AMF. This includes interests and positions in the financial sector or the fact of a mandate with a legal entity held within two years of appointment, and any representation of the foregoing, in the case of Members. Members must recuse themselves with respect to deliberations involving any matter in which they participated or provided representation with respect to such relationship.

There are also restrictions on the holding or trading of securities by staff. The direct purchase of securities and management of a portfolio are prohibited, although staff may hold mutual funds (UCITS) or give discretion to a fund manager. The AMF has extended these restrictions to Board members. The President of the AMF has powers to oversee the holdings of Members. In addition, there is an Ethics Officer which has the power to investigate violations including violations involving the Internet.

**Table 5. Summary of frameworks and processes for promoting quality regulation**

Quality Regulation Framework	Regulator									
	USA				Canada		Australia		UK	France
	FR	OCC	SEC	CFTC	OSFI	OSC	APRA	ASIC	FSA	AMF
<b>RIA / CBA</b> Statutory requirement	x	x	√*	√	x	√	x	x	√	x
Whole of gvt guidance	√	√	√	√	√	√	√	√	√	x
Executive clearance	x	√	x	x	x	x	√	√	x	x
<b>Ex post evaluation</b> Statutory requirement	√**	√**	√**	√**	x	x	x	x	x	x
National / provincial auditor / other	√	√	√	√	√	√	√	√	√	√
<b>Transparency (consultation)</b> Statutory requirement	√	√	√	√					√	√
Whole of gvt guidance	√	√	√	√	√	√	√	√	√	x
Membership of co-ordination body	√	√	√	√	√	√	√	√	√	√
<b>Integrity</b> Statutory provisions	√	√	√	√	√	√	√	√	√	√
Guidance	√	√	√	√	√	√	√	√	√	√
Revolving door	√	√	√	√	√	√	√	√	x	x
Investment dealings	√	√	√	√	√	√	√	√	√	√

\* To a limited extent.

\*\* Congressional Review Act.



## SUMMARY AND CONCLUSIONS

There is clearly a wide variety of systems and practices to ensure regulatory quality which apply to the different financial regulators. There are also a number of issues which arise from this exposition. The result could be a focus on ensuring that each financial regulator is brought up to “best practice” standards. There are wider issues, however, which may fail to be considered. Three of these are considered briefly here.

- i) *What is the relevance of the 2005 OECD Guiding Principles of Regulatory Quality and Performance in terms of the processes and the functions exhibited by the relevant financial regulators?*

This report does not attempt to analyse the contribution that any of these systems or practices made to the operation of the regulators in the period leading up to the financial crisis. Moreover, there is obviously a need for a clear and detailed analysis of the nature of and reasons for the various regulatory failures before any attempts at analysis can be made of the relationship between the presence or absence of systems and processes for regulatory quality and the performance of the regulators. This is an iterative process.

There is an emerging consensus, however, on the main regulatory shortcomings (as opposed to macroeconomic policies and other contributory causes). These include:

- The lack of co-ordinated information on macro-financial flows and on the micro-prudential supervision of individual banks, both nationally and internationally,
- The lack of integration of those two sources of information and insufficiently co-ordinated action by supervisors both nationally and internationally;
- The delineation of regulatory boundaries, which caused “black holes” to develop which were outside the regulators’ focus, notably the developments of complex credit derivatives and the use of off-balance sheet vehicles;
- The incentive structures caused by regulation itself, for example for banks to move assets onto the trading book where they would not “count” towards capital requirements;
- Significant and ultimately fatal weaknesses in risk assessments and risk management by all those involved, including but not limited to the regulators; and
- A political-economic, and hence regulatory, philosophy which, with hindsight, placed too much reliance on the ability of the market and financial institutions to regulate themselves and to self-correct.

This report points to a number of areas relating to regulatory practice where Principles could be further developed, notably with respect to risk management and the need for a detailed understanding of the system being regulated. However, as far as financial regulation is concerned, these areas have now been covered in the new Policy Framework for Effective and Efficient Financial Regulation (PFEER), released in 2009 and now adopted by the OECD at Council level, following endorsements by the Committee on Financial Markets and Insurance and Private Pensions Committee.

- ii) *Is the application of practices and principles of quality regulation aligned with the institutional structures of decision making – in other words, do they apply to the critical decision points and key decision makers in the regulatory process?*

A notable aspect of financial regulation is the extent to which central principles of regulation, particularly capital adequacy rules, are determined at the international level. Although these are “soft law” provisions, there is considerable international peer pressure for their adoption. Within the EU, the Financial Services Action Plan has led to a considerable development of EU financial law, with the result that most of the key provisions are set at EU level, and have to be implemented by member states. In Canadian securities regulation, the drive for harmonised rulemaking means that most measures are agreed at the CSA, and thus agreement has already been reached to adopt the rule prior to the CBA process that the OSC has to undertake.

In this context, the application of principles of better regulation to individual regulators at the national or provincial level, at least in so far as those principles relate to the formation of regulatory provisions, may come too late as the real decision to implement the requirements has already been made elsewhere. Moreover, the results of any *ex post* reviews may, depending on the findings, only be valuable if they can be fed back into a process for modifying the regulatory requirements. Given the complex structure of financial regulation, this iterative operation of feedback and modification mechanisms is likely to be difficult and slow to achieve.

- iii) *Is there a need for co-ordination of the principles of quality regulation to which financial regulators are subject at the international, regional and national levels?*

The report draws attention to the number of different sources of principles of quality regulation to which financial regulators are subject, and inevitably there are areas of overlap and underlap. There are core 2005 *OECD Guiding Principles of Regulatory Quality and Performance* which could be applied in the sector-specific context, for example those relating to the nature of the regulatory requirements and the provisions for their *ex ante* and *ex post* review and assessment. They have also been integrated in the newly adopted *Policy Framework for Effective and Efficient Financial Regulation (PFEEFR)*. On the other hand, there are elements of the Basle and IOSCO Principles which could apply on a “whole-of-government” basis but are not particularly developed in the OECD Principles. For example, the Basle Principles focus to a far greater extent on risk management issues, which are given less explicit focus in the OECD Principles. They also contain a provision for the need for regulators to have a clear grasp of the dynamics of the organisations and system being regulated. Whilst these issues are covered for financial institutions by the *PFEEFR*, they are of potentially wider application to areas other than financial regulation.

There are also arguably omissions from all three sets of principles that were in force in 2009, which have now been captured in the *PFEEFR*. In particular, the *PFEEFR* alone emphasises the need for regulators to develop an understanding of the implications of changes in the macro-environment for regulated firms and the system as a whole. Further, the principle on “co-ordination” which is included in the 2005 *OECD Guiding Principles of Regulatory Quality and Performance* could be expanded to include co-ordination with other regulators within the same policy domains, and with their counterparts in other countries. This was arguably not fully captured in the OECD 2005 Principles, although the new *PFEEFR* captures this aspect with respect to financial institutions. This again is a principle that could be extended more widely to other regulatory domains.

Each set of principles is has a somewhat different aim and focus and so some differentiation is appropriate. However, as indicated above, there may be value in sharing experiences and co-ordinating the different relevant principles at the national, supranational and international level.

## ANNEX A. STRUCTURES OF FINANCIAL REGULATION IN AUSTRALIA, CANADA, FRANCE, THE UK AND THE USA

### *Australia*

The institutional structure of Australian financial regulation was reformed in 1998 following the Wallis Report. It adopts the “twin peaks” model, in that responsibility for prudential and conduct of business regulation is split between two federal agencies. The Australian Prudential Regulation Authority is responsible for the prudential regulation of deposit taking institutions, insurance companies and superannuation (pension) funds.<sup>75</sup> The Australian Securities and Investments Commission is responsible for conduct of business issues with respect to deposit taking institutions, pension funds, insurance business and all securities business. The Reserve Bank of Australia is responsible for financial stability and oversight of the payment system. There is a separate body, Austrac,<sup>76</sup> which is responsible for money laundering regulation; and a deposit protection scheme was introduced in October 2008. Dispute resolution for retail customers and small businesses is performed by a new, integrated financial ombudsman created in July 2008, the Banking and Financial Services Ombudsman.

### *APRA*

APRA is a statutory corporation and is governed by a relatively small group of between 3-5 members (currently 3). Its staff are not part of the core civil service, and their pay and conditions are covered by a separate enterprise bargaining agreement to the core civil service with different pay bands.<sup>77</sup> It implements a number of separate pieces of legislation, though its objectives are set out in the APRA Act 1998. Its statutory purposes are to administer the legislative requirements on prudential regulation of financial institutions or retirement income standards and the compensation schemes for banking and insurance. APRA also administers the deposit protection scheme introduced in 2008. In performing and exercising its functions and powers, APRA is required by statute to “balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, is to promote financial system stability in Australia”.<sup>78</sup> It has broad powers to authorise banks and general insurers, to determine and administer prudential standards (though no legislative rule making powers), investigation powers, powers to order corrective action, and powers to order the compulsory transfer of business or winding up of failing institutions.

### *ASIC*

ASIC is also a statutory corporation governed by a board of 3-8 members and a full time Chair, referred to as Commissioners. There are currently six Commissioners. It was created in 1998, but its remit has since been expanded.<sup>79</sup> It administers a number of statutes, the two main ones being the ASIC Act 2001 and the Corporations Act 2001. ASIC is responsible for ensuring market integrity and consumer protection in the financial markets, and its remit covers the conduct of financial markets and authorised exchanges, the conduct of financial services organisations and professionals who deal and advise in investments, superannuation, insurance, deposit taking and credit. It has a wider brief than either FSA or OSC as it also regulates the corporate governance of companies, including non-financial companies, to ensure that company directors and officers carry out their duties honestly, diligently and in the best interests of their company, and it regulates auditors. It also oversees the conduct of corporate insolvencies and corporate insolvency practitioners.

It has a clear legislative mandate under the ASIC Act,<sup>80</sup> which is to:

- Maintain, facilitate and improve the performance of the financial system and the entities within that system in the interests of commercial certainty, reducing business costs, and the efficiency and development of the economy; and
- Promote the confident and informed participation of investors and consumers in the financial system; and
- Administer the laws that confer functions and powers on it effectively and with a minimum of procedural requirements; and
- Receive, process and store, efficiently and quickly, the information given to ASIC under the laws that confer functions and powers on it; and
- Ensure that information is available as soon as practicable for access by the public; and
- Take whatever action it can take, and is necessary, in order to enforce and give effect to the laws of the Commonwealth that confer functions and powers on it.

In contrast to APRA, its staff are considered “Australian Public Service” employees and must generally be employed under the *Public Service Act 1999 (Cth)*.<sup>81</sup> Although covered by a separate enterprise bargaining agreement, the salary bands correspond to those for APS employees. It has wide ranging powers of investigation and enforcement, but in contrast to many securities regulators it does not have formal rule making powers. While ASIC can directly issue guidance and waivers, secondary legislation must be signed into force by the Governor General, who does this based on advice from the government. In advising the Governor General, the government takes into account the advice of ASIC.

### ***Canada***

Financial regulation in Canada is fragmented both sectorally and federally. Banking, insurance and pensions supervision occurs at the federal level. Since 2001 Canada has adopted the “twin peaks” model with respect to banking and insurance, with responsibility for prudential supervision and conduct of business split between two regulatory bodies. Financial supervision of banks, insurance, trust and loan companies and pension funds is the responsibility of the Office of the Superintendent of Financial Institutions (OSFI), created in 1987. The Financial Consumer Agency of Canada was created in 2001 to oversee compliance with federal consumer protection provisions with respect to banks and all federally incorporated or registered insurance, trust and loan companies, and to monitor compliance with self regulatory codes. There is also a federal system of deposit insurance, administered by the Canadian Deposit Insurance Corporation.

In contrast, securities regulation in Canada is performed at the territorial and provincial level, with 13 separate governmental securities regulators. In the largest jurisdictions, these are independent agencies which are self-funded. The securities commissions rely significantly on the self regulatory bodies which regulate investment dealers and mutual fund dealers and trading in securities, and on the exchanges.<sup>82</sup> Although a recent FSAP review of the Canadian securities markets found that it exhibited a high level of implementation of the relevant IOSCO Principles, the fragmentation of Canadian securities regulation has been the subject of extensive national debate, and successive reviews have been appointed to consider its reform. Many of these have recommended the creation of a single federal securities regulator, including the FSAP review and the recent report of the Expert Group in January 2009, but opposition remains.

A number of attempts have been made by the provincial and territorial regulators to simplify and standardise their laws and requirements. Co-ordination is now facilitated by the Canadian Securities Administrators (CSA), a non-statutory body which provides a forum for co-ordination harmonisation of the regulation of the Canadian capital markets. Its mission is to give Canada a securities regulatory system “that protects investors from unfair, improper or fraudulent practices and to foster fair, efficient and vibrant capital markets through developing a national system of harmonised securities regulation, policy and practice.”<sup>83</sup>

#### *Ontario Securities Commission*

Ontario has a significant share of the market and its participants. Approximately 31% of listed issuers, amounting to 46% of Canada’s equity markets, are based in Ontario; 60% of investment dealers have their Canadian head office in Ontario; 76% of assets in collective investment schemes are held by firms based in Ontario; and 49% of the assets of the top 100 employer funds are also held by Ontario based pension funds.<sup>84</sup>

In common with the other securities commissions in Canada, the OSC’s statutory objectives are

- to provide protection to investors from unfair, improper or fraudulent practices and
- to foster fair and efficient capital, commodities and futures markets and confidence in their integrity.<sup>85</sup>

It is a statutory corporation without shares, and its board members are appointed by the Lieutenant Governor in Council in Ontario. Under the authority of the OSC is the Commodity Futures Advisory board, whose members are nominated by the Ministry of Finance, and its chairman is designated by the OSC board. Its staff are not members of the core civil service and it operates separate pay bands. It authorises financial institutions who wish to operate in Ontario and recognises self-regulatory bodies, exchanges and clearing houses operating within the province. It has wide ranging rule making powers, though proposed rules are subject to the authorisation of the Minister of Finance. It has investigation powers, administrative enforcement powers and can bring civil actions and criminal prosecutions for violations of securities laws. The relationship between the OSC and the Minister of Finance is set out in a Memorandum of Understanding which by statute has to be renewed every five years. The MoU the respective roles and responsibilities of the Minister and the chair of the OSC; the accountability relationship between the commission and the Minister; and the responsibility of the commission to provide to the Minister business plans, operational budgets and plans for proposed significant changes in the operations or activities of the Commission.

#### *Office of the Superintendent of Financial Institutions (OSFI)*

OSFI was created in 1987 and is under the authority of the Minister of Finance.<sup>86</sup> The Superintendent is appointed formally by the Governor in Council, in practice by the Cabinet, and has a renewable mandate of seven years. The Superintendent may appoint one or more Deputies, of which there are currently three. Its staff are not members of the civil service and it operates different pay bands, and seeks to align those to the financial sector. It aims to pay at the 75<sup>th</sup> percentile of salaries for posts of similar level in the financial industry. It supervises banks, insurers and pension plans, and the government Chief Actuary is also part of OSFI. Its objectives are

- to supervise banks, insurers and financial institutions to determine that they are in sound financial condition (and with respect to pension plans that it is meeting the minimum funding requirements);

- to promptly inform the management and board (or in the case of pensions, the administrators) if the institution or pension plan is not in sound financial condition or complying with the supervisory requirements and to take or to require the management or administrator to take any necessary corrective measures to ensure compliance;
- to promote the adoption of risk management processes by the regulated institutions and pension plans, and
- with respect to banking and insurance, to monitor and evaluate system-wide or sectoral events that may have a negative impact on the financial condition of financial institutions.<sup>87</sup>

Notably, in pursuing its objectives, amendments introduced in 1996 provide that whilst OSFI is required to protect the rights and interests of depositors, policyholders and creditors of financial institutions and beneficiaries of pension plans, it is to have “due regard to the need to allow financial institutions to compete effectively and take reasonable risks”. Moreover, the statute provides that whilst OSFI can reduce the risk of failure of a financial institution, it cannot avoid it: “regulation and supervision must be carried out having regard to the fact that boards of directors are responsible for the management of financial institutions, financial institutions carry on business in a competitive environment that necessitates the management of risk and financial institutions can experience financial difficulties that can lead to their failure.” A similar provision was introduced with respect to pension plans.<sup>88</sup> OSFI does not have legislative powers, though it can formulate guidelines and in practice exercises a significant amount of discretion in formulating guidance on capital and funding requirements. It has investigation powers, including powers to examine and inquire into the performance of any securities-related activities of the institutions that it supervises, supervisory powers, and the power to impose fines. The Minister of Finance retains powers to authorise the incorporation of banks and the operation of foreign banks in Canada.

### **France**

France reformed the legal and institutional structure of financial regulation in 2003. The new law (Financial Security Act of August 1, 2003 (*Loi N°. 2003-706, de Sécurité financière* or LSF) simplifies and consolidates the law affecting financial market institutions, products and professionals. The compilation of the statutory provisions is known as the *Code Monétaire et Financier* (COMOFI) (IMF, 2005).

The revised regulatory framework is a complex form of the “twin peaks” for banking and securities, but remains functional for insurance, for which there is a separate regulator. Overall surveillance of the financial markets in which banks and investment firms operate is shared between the AMF and the *Banque de France* (BdF). More specifically, banking supervision is divided between three bodies, the Minister of the Economy (MoE), the Commission Bancaire (CB) and the *Comité des Établissements de Crédit et des Entreprises d’Investissement* (CECEI). The staff and funding for the CB and the CECEI are provided by the central bank, the Banque de France (BdF).

There is a clear, if complex, division of roles between these bodies. Under the Financial Security Act 2003, the MoE is directly responsible for setting regulations for credit institutions and investment firms, notably also covering internal controls, minimum capital, and management standards. Licensing of credit institutions is the responsibility of CECEI. The CB is responsible for the supervision of the individual credit institutions, including banks, and of individual investment firms regard to their financial condition, operating practices and compliance with rules and regulations. The BdF, the CB and the CECEI are closely connected through joint staff and chairmanship.

The AMF is an “independent public authority” with legal personality. It is also a “taxing” authority and charges fees. It is comprised of a 16 member Board, chaired by a full time Chairman and a separate 12-member *Commission des Sanctions*, and 5 consultative commissions, each with its own Chairman and Vice Chairman. The AMF is the sole agency responsible for asset management firms. For other investment firms, it shares responsibility for licensing with CECEI and for supervision with CB. Unlike the banking regulators, the AMF has rule making powers.

The AMF has broad sanctioning powers which must be exercised through its separately constituted *Commission des Sanctions*. Proceedings before this panel can be commenced against any person, whether or not that person is a regulated person. The Secretary General of the AMF opens investigations, which remain under his authority until referred to the *rappporteur* designated by the *Commission des Sanctions*. Cases may be referred to the *Commission des Sanctions* by the AMF board, based on a report of an investigation undertaken by the Secretary General. They can also be referred by the AMF board, upon review of a file submitted by the Governor of the BdF, or the Chairman of either of the CB or the CCAMIP (L.621-15) (IMF, 2005).

## UK

The UK has an integrated financial regulator which is separate from the central bank, the Bank of England. There is a Memorandum of Understanding between the regulator (the Financial Services Authority (FSA)), the Bank of England and the Treasury, known as the Tripartite Arrangement, which sets out their respective responsibilities. As a result of the financial crisis, and in particular the handling of the nationalisation of the bank Northern Rock, new statutory arrangements have been introduced with regards to the management of failing banks and the role each of these three bodies plays in the process.<sup>89</sup> The Bank of England is also expected to play a greater role in the future in ensuring macro-prudential stability than it has done since its supervisory powers were transferred to the FSA in 1997.

### *Financial Services Authority*

The Financial Services Authority (FSA) is an integrated regulator whose jurisdiction covers the whole of the UK.<sup>90</sup> It regulates both the financial soundness and conduct of business of financial institutions in the UK, and administers the money laundering regulatory regime. It was formed in 1997 and received its full statutory powers on 1<sup>st</sup> December 2001 under the Financial Services and Markets Act 2000 (FSMA). It is not established by statute, but is an incorporated body under the Companies Act 1985. FSMA radically reformed the regulation of financial services in the UK, and gave the powers of nine previous regulatory bodies to the FSA. It also consolidated and replaced previous legislation governing the regulation of financial institutions, so, in contrast to the regulators in Canada and Australia, the FSA receives powers under, and has to administer, a single piece of legislation.

The FSA regulates those who engage specified activities including deposit taking, dealing, managing or arranging investments, general insurance and long term care insurance, or providing investment advice including mortgage advice. The FSA’s remit is due to expand to cover the relationship between deposit takers and their customers, which has historically has been subject to a self regulatory regime run by the British Banking Association. It acts as the UK Listing Authority for the London Stock Exchange, and recognises and oversees recognised exchanges, clearing houses, Lloyds insurance market. In addition, FSMA established a regulatory regime for individuals performing specified “controlled” functions in performing regulated activities.<sup>91</sup> These functions relate to the management of a firm, dealing with customers, and dealing with the property of customers. Such individuals (referred to as “approved persons”) must be notified to the FSA, who must be satisfied that the person is “fit and proper” to perform the function to which the application relates. Approved persons are subject to a separate set of principles and code, contained in the Handbook.<sup>92</sup>

The FSA's members, officers and staff are not part of the civil service and it sets its own pay scales. It is funded through fees levied on the regulated industry, which it sets itself without Ministerial involvement. The FSA is required to have a Chairman and a governing body, of which the Chairman must be a member.<sup>93</sup> The Chairman and governing body must be appointed, and are liable to removal from office on specified grounds, by the Treasury. The FSA must ensure that the majority of board members must be non-executives.<sup>94</sup> There are currently three managing directors and eleven non-executive Board members, in addition to the Chairman and Chief Executive.

The FSA is required to establish a committee of non-executive Board members, the chairman of which committee is to be appointed by the Treasury.<sup>95</sup> The non-executive committee is required to carry out a range of functions including: keeping under review the question of whether the FSA is using its resources in an efficient and economic way, and whether it has adequate internal financial controls; determining the remuneration of the Authority's governing body and its executive members. The non-executive committee must prepare a report on the discharge of its functions to be submitted to the Treasury with the FSA's annual report.<sup>96</sup>

The FSA has four statutory objectives which apply to the discharge of its "general functions". These are:

- the maintenance of market confidence in the UK financial system;
- promoting public understanding of the financial system;
- securing the appropriate degree of protection for consumers; and
- reducing the scope for financial crime.<sup>97</sup>

In discharging its statutorily defined general functions the FSA is also required to have regard to seven principles of good regulation.<sup>98</sup> These are:

- the need to use its resources in the most efficient and economic way;
- the responsibilities of those who manage the affairs of regulated firms;
- the principle of proportionality;
- the desirability of facilitating innovation in connection with regulated activities;
- the international character of financial services and the desirability of maintaining the competitive position of the UK;
- the need to minimise the adverse effects on competition of regulation; and
- the desirability of facilitating competition between those being regulated.

The FSA's general functions are those of:

- making rules;
- preparing and issuing codes;



- giving general guidance; and
- determining the general policy and principles by reference to which it performs its particular functions.<sup>99</sup>

In discharging those functions, the FSA must, so far as is reasonably practicable, act in a way which is compatible with the regulatory objectives, and which it considers is most appropriate for the purpose of meeting those objectives.<sup>100</sup> The FSA has wide ranging powers of authorisation of financial institutions, rule making, investigation and enforcement. It is also required to establish and oversee the Financial Services Compensation Scheme and the Financial Ombudsman Scheme. It has two statutory advisory panels, the Consumer Panel and the Practitioner Panel, and has created a third, the Small Business Panel. Appeals from the decisions of the FSA are heard by the specialist Financial Services Appeal Tribunal, from which appeal lies to the courts. There is also a separate body to whom the general public can complain about the work of the FSA, the Complaints Commissioner. Its rules are subject to review on competition grounds by the Office of Fair Trading.

## *US*

The US has a highly fragmented regulatory structure, characterised by specialisation and competition between regulators (GAO, 2007). Insurance regulation operates at the state level; regulation of securities markets operates at the federal level with a significant involvement of self-regulatory organisations; and banking regulation operates at both state and federal level, with institutions having a choice as to who to be regulated by.

In banking, there are a number of types of charter than an institution can have. Bank charter types include:

- commercial banks
- thrifts, which include savings banks, savings and loans, savings associations, created originally to serve the needs of those not served by commercial banks
- credit unions, which are owned by member co-operatives
- industrial loan companies (ILCs), which are state chartered financial institutions; these have grown from small limited purpose institutions to include some of the US's largest and more complex financial institutions.

With the exception of ILCs, the other institutions may be chartered at state or federal level, though if they offer federal deposit insurance they will have a primary federal regulator (GAO, 2007).

The main federal regulators for banking institutions are:

- Office of the Comptroller of the Currency (OCC), which charters and supervises national banks;
- The Federal Reserve, which is the regulator for state-chartered banks which opt to be members of the Federal Reserve System and companies that own or control banks (bank holding companies)
- The Federal Deposit Insurance Corporation, which supervises all other state chartered commercial banks with federally insured deposits, and federally insured state savings banks;

- Office of Thrift Supervision, which charters and supervises federally chartered savings institutions and thrift holding companies
- The National Credit Union Association, which charters and supervises federally chartered credit unions.

In securities and futures, regulation is a combination of federal regulation and self regulation. At the federal level the main regulators are the Securities and Exchange Commission (SEC) and the Commodities and Futures Trading Commission (CFTC). They are responsible for administering and enforcing federal securities and futures laws, and overseeing the self regulatory organisations (SROs).

In the securities industry, the principal SRO is the Financial Industry Regulatory Authority (FINRA). It was formed in 2007 through the merger of the National Association of Securities Dealers and the member regulation, enforcement and arbitration functions of the New York Stock Exchange. FINRA regulates approximately 5,000 brokerage firms, 173,000 branch offices and 659,000 registered securities representatives. In the futures industry, SROs include the futures exchanges and the National Futures Association. SROs are responsible for establishing standards for the conduct of business of their members, monitoring compliance with those standards and bringing enforcement actions for violation of their own rules, federal securities laws and SEC or CFTC rules.

The development of the financial industry has caused some issues relating to jurisdiction of the different regulators. The emergence of financial derivatives has caused difficulties as to who should have jurisdiction over them, the SEC or the CFTC. The GAO has also examined the jurisdictional issues with respect to large financial holding companies, which manage and control risks on a consolidated basis (GAO, 2007). Holding companies for groups which include banks are regulated by the Federal Reserve; holding companies for groups which include thrifts but not banks are regulated by the OCC (even though “banks” and “thrifts” can be alike in operations and scale), and certain holding companies that own broker-dealers can elect to be supervised by the SEC as consolidated supervised entities (CSEs). Holding company supervisors oversee the holding company, and the appropriate functional regulator is primarily responsible for regulating the relevant subsidiary (GAO, 2007).

Four of the federal regulators are examined in this report: the Federal Reserve, the OCC, the SEC and the CFTC.

### *Federal Reserve*

The Federal Reserve System was created in 1913 as the US central bank. The System consists of a seven member Board of Governors with headquarters in Washington, D.C., and twelve Reserve Banks located in major cities throughout the United States. It is the Central Bank of the United States which also plays the role of banking regulator along with other co-existing regulators.<sup>101</sup>

It has four main roles:

- Monetary policy: The primary responsibility of the Board members is the formulation of monetary policy. The seven Board members constitute a majority of the 12-member Federal Open Market Committee (FOMC), the group that makes the key decisions affecting the cost and availability of money and credit in the economy.
- Supervision of the payments system.
- Regulation and supervision of:

- banks that are members of the System (*i.e.* all national banks and those state banks that have elected to become members),
- bank holding companies,
- international banking facilities in the United States,
- Edge Act and agreement corporations (through which U.S. banking organisations may conduct international banking activities),
- foreign activities of member banks, and
- the U.S. activities (banking and non-banking) of foreign-owned banks
- approval of foreign banks owning more than 5% of a US bank.
- Consumer credit – development and administration of federal laws on consumer credit.
- Setting margin requirements, which limit the use of credit for purchasing or carrying securities.

The seven members of the Board of Governors are appointed by the President and confirmed by the Senate to serve 14-year terms of office. Members may serve only one full term, but a member who has been appointed to complete an unexpired term may be reappointed to a full term. The President designates, and the Senate confirms, two members of the Board to be Chairman and Vice Chairman, for four-year terms.<sup>102</sup>

Its decisions do not have to be ratified by the President or anyone else in the executive or legislative branch of government, it does not receive funding appropriated by Congress, and the terms of the members of the Board of Governors span multiple presidential and congressional terms.

However, the Federal Reserve is subject to oversight by Congress, which periodically reviews its activities and can alter its responsibilities by statute. It is under a statutory obligation to report annually on its activities to the Speaker of the House of Representatives, and twice annually on its plans for monetary policy to the banking committees of Congress. Officials also testify before Congress when requested.

The Federal Reserve's income is derived primarily from the interest on U.S. government securities that it has acquired through open market operations. Other sources of income are the interest on foreign currency investments held by the System; fees received for services provided to depository institutions, such as check clearing, funds transfers, and automated clearinghouse operations; and interest on loans to depository institutions (the rate on which is the so-called discount rate). After paying its expenses, the Federal Reserve turns the rest of its earnings over to the U.S. Treasury. There were 2 489 member banks in 2007.

## *OCC*

The US's dual system of state and federal banks was created in 1863, when in an effort to finance its Civil War debt, Congress introduced a federal bank charter, and established the Office of the Comptroller of the Currency (OCC) as the office in charge of chartering and overseeing the newly created national banks (US Treasury, 2008).

The OCC is a bureau within the US Treasury Department. The Department is organised into two major components: the Departmental offices and the operating bureaus. The Departmental Offices are primarily responsible for the formulation of policy and management of the Department as a whole, while the operating bureaus carry out the specific operations assigned to the Department. Bureaus make up 98% of the Treasury work force.

In addition to the supervision of national banks, the OCC is responsible for the administration of all laws passed by Congress relating to the issue and regulation of a national currency secured by United States bonds and, under the general supervision of the Board of Governors of the Federal Reserve System, of all Federal Reserve notes, except for the cancellation and destruction, and accounting with respect to such cancellation and destruction, of Federal Reserve notes unfit for circulation.

Although it is a bureau within the US Treasury Department, the Comptroller of the Currency is appointed by the President and confirmed by the Senate for a five year term. He may be removed by the President. The Treasury Secretary appoints up to four Deputies, and determines their salaries. The Comptroller is required to perform his duties under the general directions of the Secretary of State of the Treasury, but the Secretary of the Treasury may not delay or prevent the issuance of any rule or the promulgation of any regulation by the Comptroller of the Currency.

The OCC's revenue is derived primarily from assessments and fees paid by national banks and income on investments in U.S. Treasury securities. The OCC does not receive congressional appropriations to fund any of its operations. Its total revenue in 2007 was \$695.6m (OCC Annual Report, 2007).

### *SEC*

The Securities and Exchange Commission is an independent federal agency established pursuant to the Securities Exchange Act of 1934. It has broad authority to enforce federal securities laws. Its stated mission is "to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation (SEC, 2008)."<sup>103</sup> Following the introduction of the Sarbanes-Oxley Act 2002 it also regulates external auditors and internal audit committees of company boards.

Its board is comprised of a bipartisan five-member Commission, consisting of the Chairman and four Commissioners, who are appointed by the President and confirmed by the Senate. Terms are five-year periods with the term of one commissioner expiring each year. By law, no more than three of the Commissioners may belong to the same political party, ensuring non-partisanship. The President cannot remove commissioners except for misconduct.

It is self-funded through fees, and its operating budget in 2008 was \$843 million. It employs approximately 3 500 staff and oversees nearly 18,000 broker-dealers and investment advisors, and nearly 940 investment company complexes (SEC, 2008b).

The SEC has wide ranging powers. Its executive powers are to:

- Administer and enforce federal securities laws
- Co-ordinate enforcement of U.S. securities laws with securities administrators outside the United States
- Initiate court action to seek injunctive relief

- Refer matters involving violations of securities laws to the Justice Department for criminal prosecution

The SEC promulgates rules and regulation that either have the force of law or carry significant weight in the courts. Examples include:

- Regulations in the Federal Register
- Guidelines
- Interpretive releases
- Interpretive letters
- No-action letters

The SEC also has judicial powers. It acts as an original tribunal, reviewing disciplinary charges against securities professionals subject to SEC supervision. It also acts as an appellate tribunal, reviewing disciplinary actions taken by self-regulatory organisations (SROs) against their members.

### *CFTC*

The CFTC was created originally to regulate agricultural futures contracts. It was established by the Commodity Futures Trading Commission Act of 1974 which invested it with the authority to regulate futures contracts on commodities. Unlike the SEC, the CFTC requires reauthorisation from Congress. The Commission's mandate was renewed and/or expanded in 1978, 1982, 1986, 1992, and 1995. In 2000, Reauthorisation came as part of the Commodity Futures Modernisation Act of 2000 (CFMA). In 2008, the CFTC was reauthorised through the Farm Bill.<sup>104</sup>

The Commission consists of five Commissioners appointed by the President, with the advice and consent of the Senate, to serve staggered five-year terms. The President designates one of the Commissioners to serve as Chairman. The Senate must separately provide confirmation of the Chairman designation. No more than three of the Commissioners may belong to the same political party, ensuring non-partisanship. The President cannot remove commissioners except for misconduct.

The jurisdiction of the CFTC has expanded since its creation. As financial futures developed, these new types of derivative contracts were no longer based on agricultural commodities (such as stock indices and interest rates). Legislation sought to refine the definition of a commodities futures contract and what fell within the authority of the CFTC. The Futures Trading Act 1982 divided SEC and CFTC regulatory responsibility over stock index futures. In 2000, the Commodities Futures Modernisation Act repealed the ban on futures contracts based on individual securities and narrow-based securities indexes and instituted a regulatory framework for such products to be administered jointly by the CFTC and the SEC. Under this framework, the CFTC retains exclusive jurisdiction over futures contracts on broad-based stock indices. The Act also codified the principal provisions of a new regulatory framework adopted earlier by the Commission, which can be characterised as principles-based. However it also determined that OTC derivatives transactions were to be largely outside the CFTC's jurisdiction (US Treasury, 2008).

The CFTC oversees the following:

- Designated Contract Markets (DCNs) – Organized Futures Exchanges
- Derivatives Clearing Organisations
- Market participants and intermediaries including:
  - Futures commission merchants
  - Introducing brokers;
  - Commodity pool operators;
  - Commodity trading advisers; and
  - Floor brokers and floor traders
- Self-Regulatory Organisations – CFTC provides oversight of SROs within DCN's and Market Participants

Companies and individuals who handle customer funds, solicit or accept orders, or give trained advice must apply for CFTC registration through the National Futures Association (NFA), an SRO with delegated oversight authority from the Commission. The Commission regulates the activities of nearly 68 000 registrants. It is funded through Congress approved appropriations and its budget in 2008 was USD 111.2 million with a staff of 448 (CFTC, 2008).

It has rule making powers, and wide ranging powers of administrative sanctions. These include

- Suspending, denying, or restricting registration and exchange trading privileges
- Imposing civil monetary penalties
- Cease and desist orders
- Orders of restitution
- Temporary Restraining Orders
- Appointment of a receiver
- Freezing of assets

When the Enforcement Division obtains evidence that criminal violations have occurred, it may refer the matter to the Department of Justice for prosecution.

## ANNEX B. BASLE COMMITTEE ON BANKING SUPERVISION, CORE PRINCIPLES FOR BANKING SUPERVISION 2006

***Principle 1 – Objectives, independence, powers, transparency and co-operation:*** An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

***Principle 2 – Permissible activities:*** The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined and the use of the word “bank” in names should be controlled as far as possible.

***Principle 3 – Licensing criteria:*** The licensing authority must have the power to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the ownership structure and governance of the bank and its wider group, including the fitness and propriety of Board members and senior management, its strategic and operating plan, internal controls and risk management, and its projected financial condition, including its capital base. Where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.

***Principle 4 – Transfer of significant ownership:*** The supervisor has the power to review and reject any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.

***Principle 5 – Major acquisitions:*** The supervisor has the power to review major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and confirming that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

***Principle 6 – Capital adequacy:*** Supervisors must set prudent and appropriate minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the applicable Basel requirement.

***Principle 7 – Risk management process:*** Supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process (including Board and senior management oversight) to identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution.

**Principle 8 – Credit risk:** Supervisors must be satisfied that banks have a credit risk management process that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control credit risk (including counterparty risk). This would include the granting of loans and making of investments, the evaluation of the quality of such loans and investments, and the ongoing management of the loan and investment portfolios.

**Principle 9 – Problem assets, provisions and reserves:** Supervisors must be satisfied that banks establish and adhere to adequate policies and processes for managing problem assets and evaluating the adequacy of provisions and reserves.

**Principle 10 – Large exposure limits:** Supervisors must be satisfied that banks have policies and processes that enable management to identify and manage concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.

**Principle 11 – Exposures to related parties:** In order to prevent abuses arising from exposures (both on balance sheet and off balance sheet) to related parties and to address conflict of interest, supervisors must have in place requirements that banks extend exposures to related companies and individuals on an arm's length basis; these exposures are effectively monitored; appropriate steps are taken to control or mitigate the risks; and write-offs of such exposures are made according to standard policies and processes.

**Principle 12 – Country and transfer risks:** Supervisors must be satisfied that banks have adequate policies and processes for identifying, measuring, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate provisions and reserves against such risks.

**Principle 13 – Market risks:** Supervisors must be satisfied that banks have in place policies and processes that accurately identify, measure, monitor and control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

**Principle 14 – Liquidity risk:** Supervisors must be satisfied that banks have a liquidity management strategy that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control liquidity risk, and to manage liquidity on a day-to-day basis. Supervisors require banks to have contingency plans for handling liquidity problems.

**Principle 15 – Operational risk:** Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor and control/mitigate operational risk. These policies and processes should be commensurate with the size and complexity of the bank.

**Principle 16 – Interest rate risk in the banking book:** Supervisors must be satisfied that banks have effective systems in place to identify, measure, monitor and control interest rate risk in the banking book, including a well defined strategy that has been approved by the Board and implemented by senior management; these should be appropriate to the size and complexity of such risk.

**Principle 17 – Internal control and audit:** Supervisors must be satisfied that banks have in place internal controls that are adequate for the size and complexity of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.



***Principle 18 – Abuse of financial services:*** Supervisors must be satisfied that banks have adequate policies and processes in place, including strict “know-your-customer” rules, that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.

***Principle 19 – Supervisory approach:*** An effective banking supervisory system requires that supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups, and also of the banking system as a whole, focusing on safety and soundness, and the stability of the banking system.

***Principle 20 – Supervisory techniques:*** An effective banking supervisory system should consist of on-site and off-site supervision and regular contacts with bank management.

***Principle 21 – Supervisory reporting:*** Supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on both a solo and a consolidated basis, and a means of independent verification of these reports, through either on-site examinations or use of external experts.

***Principle 22 – Accounting and disclosure:*** Supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally, and publishes, on a regular basis, information that fairly reflects its financial condition and profitability.

***Principle 23 – Corrective and remedial powers of supervisors:*** Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability, where appropriate, to revoke the banking licence or to recommend its revocation.

***Principle 24 – Consolidated supervision:*** An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.

***Principle 25 – Home-host relationships:*** Cross-border consolidated supervision requires co-operation and information exchange between home supervisors and the various other supervisors involved, primarily host banking supervisors. Banking supervisors must require the local operations of foreign banks to be conducted to the same standards as those required of domestic institutions.

## **ANNEX C. IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION 2002 (UPDATED FROM 1997)**

The principles are based on three objectives of securities regulation. These are:

- The protection of investors;
- Ensuring that markets are fair, efficient and transparent;
- The reduction of systemic risk.

The 30 principles need to be practically implemented under the relevant legal framework to achieve the objectives of regulation described above. The principles are grouped into eight categories.

### **A. Principles Relating to the Regulator**

1. The responsibilities of the regulator should be clear and objectively stated.
2. The regulator should be operationally independent and accountable in the exercise of its functions and powers.
3. The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.
4. The regulator should adopt clear and consistent regulatory processes.
5. The staff of the regulator should observe the highest professional standards including appropriate standards of confidentiality.

### **B. Principles for Self-Regulation**

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, to the extent appropriate to the size and complexity of the markets.
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.

### **C. Principles for the Enforcement of Securities Regulation**

8. The regulator should have comprehensive inspection, investigation and surveillance powers.
9. The regulator should have comprehensive enforcement powers.
10. The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance programme.

#### **D. Principles for Co-operation in Regulation**

11. The regulator should have authority to share both public and non-public information with domestic and foreign counterparts.
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.
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.

#### **E. Principles for Issuers**

14. There should be full, timely and accurate disclosure of financial results and other information that is material to investors' decisions.
15. Holders of securities in a company should be treated in a fair and equitable manner.
16. Accounting and auditing standards should be of a high and internationally acceptable quality.

#### **F. Principles for Collective Investment Schemes**

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.
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.
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.
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.

#### **G. Principles for Market Intermediaries**

21. Regulation should provide for minimum entry standards for market intermediaries.
22. There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.
23. Market intermediaries should be required to comply with standards for internal organisation 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.
24. There should be procedures for dealing with the failure of a market intermediary in order to minimise damage and loss to investors and to contain systemic risk.

## **H. Principles for the Secondary Market**

25. The establishment of trading systems including securities exchanges should be subject to regulatory authorisation and oversight.
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.
27. Regulation should promote transparency of trading.
28. Regulation should be designed to detect and deter manipulation and other unfair trading practices.
29. Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.
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.

## ANNEX D. CODES INCLUDED IN THE WORLD BANK & IMF REPORT ON STANDARDS AND CODES REVIEW

The IMF and the World Bank have recognised international standards in 12 areas, which may be divided into three groups:

**(1) Policy Transparency:** Standards in these areas were developed, and are assessed, by the IMF:

- Data Transparency: IMF's Special Data Dissemination Standard (SDDS) and General Data Dissemination System (GDDS).
- Fiscal Transparency: IMF's Code of Good Practices on Fiscal Transparency, complemented by the Guide on Resource Revenue Transparency.
- Monetary and Financial Policy Transparency: IMF's Code of Good Practices on Transparency in Monetary and Financial Policies.

**(2) Financial Sector Regulation and Supervision:** These standards are typically assessed in the context of the joint IMF-World Bank Financial Sector Assessment Program (FSAP):

- Banking Supervision: Basel Committee on Banking Supervision's Core Principles for Effective Banking Supervision.
- Securities: International Organization of Securities Commission's Objectives for Securities Regulation.
- Insurance: International Association of Insurance Supervisors' Insurance Supervisory Principles.
- Payments Systems: Committee on Payments and Settlements Systems' Insurance Supervisory Principles, complemented by Recommendations for Securities Settlement Systems for countries with significant securities trading.
- Anti-Money Laundering and Combating the Financing of Terrorism: Financial Action Task Force's (FATF) 40+9 Recommendations.

**(3) Market Integrity:** Standards in these areas have been developed by various institutions, including the World Bank. These are usually assessed by the World Bank:

- Corporate Governance: Organization of Economic Co-operation and Development's Principles of Corporate Governance.
- Accounting: International Accounting Standards Board's International Accounting Standards.
- Auditing: International Federation of Accountants' International Standards on Auditing.

## NOTES

1. For more detail, see [www.oecd.org/gov/ethics/conflictinterest](http://www.oecd.org/gov/ethics/conflictinterest) of the Global Financial Crisis.
2. See [www.imf.org/external/NP/fsap/fsap.asp](http://www.imf.org/external/NP/fsap/fsap.asp).
3. The institutional landscape presented here was the one that prevailed before the Global Financial Crisis (GFC), as it was relevant to the practices that existed and had been established up to 2008 and which are analysed in this report.
4. The basis for the Report on Observance of Standards and Codes (ROSC) conducted by the IMF and World Bank are the 12 key standards for sound financial systems designated by the Financial Stability Forum (see [www.fsforum.org/cos/key\\_standards.htm](http://www.fsforum.org/cos/key_standards.htm)). These are set out at Annex D.
5. The research assessed five different dimensions of an agency's structure and relationship with the executive and legislature: the status of the agency head and that of members of the management board; the relationship with government and parliament; financial and organizational autonomies; and regulatory competencies. These five dimensions were then used to develop indices of formal independence based on the work done on central banks. The regulators were those responsible for competition, electricity, the environment, financial markets, food safety, pharmaceuticals, and telecommunications. The countries were Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the UK.
6. This finding is explained on the basis of the influential "credible commitments" thesis, which is that independent regulatory agencies are created to give a "credible commitment" to potential investors that the government will not renege on its commitments to liberalise the markets, thus attracting private, and in many cases, foreign investment (Levy & Spiller 1994; 1996). The argument is that such commitments do not need to be made in social regulation in the same way or to the same degree, so it is not so politically important to have independent regulatory agencies in these areas, hence their lower independence scores.
7. Gilardi explains the relationship between independence and the political and institutional context on the basis that, for regulatory policy, veto players and stable political environments constitute a functional equivalent of delegation in that they increase policy stability and thereby increase the credibility of any policies adopted with respect to particular sectors, thus making delegation less necessary (Gilardi, 2008, pp. 58-67).
8. Gilardi found that regulatory agencies have spread in an interdependent process of diffusion. The establishment of an independent regulatory agency in a given country and sector is in part influenced by decisions in that sector in other countries, and by decisions in other sectors in the same country. Indeed, controlling for country-specific pressures and EU legislation, and all else being equal, he found that the establishment of a new agency is about five times more likely if independent regulators are widespread (either in the country or in the sector) than if they are a novelty.
9. Magetti 2008. He examined 16 regulators in three different sectors (banking and finance, telecoms and competition) in 10 different countries. In assessing independence he focused on four areas of the agency's operation: its employees, resources, rule making and board membership. He then compared the measurements against the formal measure of independence arrived at by Gilardi, and related it to several institutional factors: the age of the agency, the number of veto players; whether the agency was operating in a country with a co-ordinated market economy or not, and the extent to which the agency was a participant in a European network of agencies.
10. It is worth noting that Magetti found no effects of path dependence on independence. In other words, even if the sector or issue had been regulated by ministers prior to the establishment of the agency, this had no effect either way on the *de facto* independence of the agency. He also found that there is high *de facto*

independence from government where regulators are not engaged in European networks, but high degree of independence from regulatees when they are, particularly if the agency had also been established for some time. Finally, Magetti assessed independence against the degree to which the political economy of the country was one of liberal or co-ordinated capitalism. He found a higher degree of independence from government in co-ordinated market economies. He argued this was surprising as he assumed the networks of relationships with politicians would be denser. However as such economies tend to have more veto players in their institutional structures, the finding might in fact fit with his other results.

11. s.11AF Banking Act, s.32 Insurance Act, s.230A Life Insurance Act.
12. FSMA s.150.
13. ASIC Act 2001 s.14(1).
14. s.50 APRA Act.
15. s.648 Bank Act 1991.
16. Statement of Expectations for the Australian Prudential Regulation Authority, Treasurer of Australia, February 2007.
17. FSMA Sched 1, para 4.
18. Completed inquiries include “Shareholder Engagement and Participation” completed on 24 June 2008, “Corporations Legislation Amendment (Simpler Regulatory System) Bill 2007 and Related Bills” completed on 19 June 2007, and “Regulation of Property Investment Advice” completed on 23 June 2005. 9 inquiries were also completed between 2004-07, and 2 inquiries between 2008 and present.
19. For example, Madoff Investment Securities Fraud: Regulatory and Oversight Concerns and the Need for Reform, Senate Committee on Banking, Housing, and Urban Affairs (January 27, 2009); Financial Crisis and Role of Federal Regulators, House of Representatives, Committee on Oversight and Government Reform (October 23, 2008); Testimony of Christopher Cox, Chairman of the U.S. Securities and Exchange Commission, Senate Committee on Banking, Housing, and Urban Affairs (September 23, 2008).
20. FSMA Sched 1, para 3.
21. Regulatory guides set out: How ASIC will exercise specific powers granted to it under legislation; How it will interpret the law; Explain the principles underlying ASIC’s approach, and provide practical guidance for regulated entities regarding, for example how they can meet their obligations. Instruments are declarations by ASIC which exempt specified regulated entities from particular legislative provisions, make specified regulated entities subject to particular legislative provisions, and/or modify or clarify the operation of certain legislative provisions. Class orders are instruments that have a wider application.
22. FSMA s.167 and 168.
23. (Sections 16 and 17 of the OSC Act).
24. Advisers and fund managers are required to complete a risk assessment questionnaire. This questionnaire must be filled out every two years and the OSC risk assessment model is updated accordingly. As in the case of the MFDA and the IDA, the OSC ranks market participants according to four defined risk categories and uses the results to monitor activities of market participants on an ongoing basis and determine the frequency and extent of on-site inspections. OSC’s goal is to review annually all intermediaries that are rated as high risk, roughly 60% of those rated medium risk and a sample of the medium-low and low risk. AR 2007.

25. Bank Act s.646-7.
26. Bank Act s.644.
27. Bank Act s.645.
28. FSA Handbook of Rules and Guidance, chapter 13 (Enforcement).
29. FSMA ss.56-58.
30. S.206 (penalties) and S.205 (statements of misconduct).
31. Ss. 380-384.
32. S.56.
33. FSMA ss.380-384.
34. s.11CA Banking Act, s.104 Insurance Act.
35. s.18A Banking Act, s.126 Insurance Act.
36. s.65A Banking Act, s.129D Insurance Act.
37. See *e.g.* evidence of Lord Turner, chairman of the FSA, to the Treasury Select Committee, 25 February 2009.
38. For more detail, see [www.oecd.org/gov/ethics/conflictinterest](http://www.oecd.org/gov/ethics/conflictinterest).
39. Congressional Review Act s.801.
40. U.S Federal Register Vol. 58, No. 190- Presidential Documents.
41. Statement of Steven D. Aitken, before the Subcommittee on commercial and Administrative Law of the Committee on the Judiciary, U.S House of Representatives, 13 February 2007.
42. [www.finance.gov.au/obpr/about/charter.html](http://www.finance.gov.au/obpr/about/charter.html).
43. See [www.regulation.gc.ca/directive/directive01-eng.asp](http://www.regulation.gc.ca/directive/directive01-eng.asp).
44. See [www.finance.gov.au/obpr/proposal/gov-requirements.html](http://www.finance.gov.au/obpr/proposal/gov-requirements.html).
45. The FSA's view of the legal justification for this, at least with respect to the "high level" CBA, is set out in the Guide, Annex 5.
46. Regulatory failure is defined as "an intervention whose economic costs were higher or economic benefits lower than was originally expected such that the net effect is harmful or more harmful than it need have been. This typically happens where regulation has unforeseen and unintended effects arising from interaction with a specific characteristic of the market affected." Guide, Para 11.
47. Securities Exchange Act, s. 3(f).
48. Securities Exchange Act, s. 23(a)(2).



49. Commodity Futures Modernization Act (CFMA), s. 119.
50. [www.finance.gov.au/obpr/consultation/gov-consultation.html](http://www.finance.gov.au/obpr/consultation/gov-consultation.html).
51. See [www.rba.gov.au/financialsystemstability/australianregulatoryframework/cfr.html](http://www.rba.gov.au/financialsystemstability/australianregulatoryframework/cfr.html).
52. Banking Act 2009.
53. Executive Order 12631 – Working Group on Financial Markets (March 13, 1988).
54. European Commission, Communication for the Spring European Council: Driving the European Recovery, Brussels, 4.3.2009, COM(2009) 114 final.
55. While these developments are presented to present the report into context, it is not the purpose of the current report to assess any of these developments, as it is focused on regulatory management practices which already existed in 2008, based on the then existing supervisory and regulatory arrangements.
56. An Act to amend the law governing financial institutions and to provide for related and consequential matters 2007.
57. The Council is a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions.
58. OSFI Act s.19-20.
59. *Criminal Code*, paragraph 121(1)(c).
60. OSFI Code of Practice on Conflicts of Interest.
61. OSFI Act s.21(2).
62. APRA Act s.17(2).
63. APRA Act s.17(3).
64. APRA Act s.48A(1)
65. APRA Code of Conduct, July 2007, p.12.
66. ASIC Act s.123(1).
67. ASIC Act s.124.
68. FSMA s.348.
69. FSA Code of Conduct, revised December 2008.
70. U.S. Code 18 Section 207: § 207 Restrictions on Former Officers.
71. “Practice by former members and employees of the Commission” Code of Federal Regulations, Title 17: Commodity and Securities Exchanges; Part 200; § 200.735-8.
72. Code of Federal Regulations: Title 17, Section 200.735-5.

73. Code of Federal Regulations: Title 17, Section 140.735-2.
74. Sec. 3101.108 Additional rules for Office of the Comptroller of the Currency.
75. Banks, credit unions, building societies, general insurance and reinsurance companies, life insurance, friendly societies, and most members of the superannuation industry.
76. The Australian Transaction and Reports Analysis Centre.
77. APRA Employment Agreement 2008, p.8.
78. APRA Act s.8.
79. It was established by statute in 1989, began operating as the Australian Securities Commission in 1991. In 1998 its remit was expanded to include consumer protection in superannuation, insurance, deposit taking and, from 2002, credit and its name changed to ASIC.: ASIC Act 2001.
80. s.1(2) ASIC Act.
81. s.120(1) ASIC Act.
82. The main SROs are now *i*) the Investment Industry Regulatory Organisation of Canada, which regulates investment dealers and all trading in member debt and equity markets in Canada (*i.e.* trading on the Toronto Stock Exchange (TSX), the TSX Venture Exchange and the Canadian National Stock Exchange for emerging companies), and a number of alternative trading systems; it was created in 2008 through a merger of the Investment Dealers Association of Canada (IDA) and Regulation Services Inc, a self-regulatory body to which some of the exchanges had sub-contracted some of their regulatory functions; *ii*) the Mutual Fund Dealers Association of Canada (MFDA), which has powers over mutual fund dealers; *iii*) the Chambre de la sécurité financière (CSF), which regulates mainly mutual fund representatives in Quebec; In addition, the Montréal Exchange (MX) is recognized as an SRO, and the equity exchanges (the Toronto Stock Exchange (TSX) and the TSX Venture Exchange (TSX V) retain some regulatory functions which have not been outsourced.
83. Canada to introduce a national securities act this year; see [www.budget.gc.ca/2009/plan/bpc3a-eng.asp](http://www.budget.gc.ca/2009/plan/bpc3a-eng.asp).
84. IMF FSAP Report, Para 14.
85. The OSC administers two Acts, the Securities Acts and the Commodities and Futures Act; the objectives are similar between the two Acts.
86. Office of the Superintendent of Financial Institutions Act 1987 which created a single regulatory agency responsible for the regulation and supervision of all federally chartered, licensed or registered banks, insurance companies, trust and loan companies, co-operative credit associations and fraternal benefit societies.
87. OSFI Act s.4.
88. OSFI Act ss.4(3) and 4(4). The provision applies mutatis mutandis to pension plans.
89. Banking Act 2009.
90. Financial services regulation is not a devolved function under the devolution Acts.
91. FSMA s.61.

92. FSA Handbook of Rules and Guidance, Statements of Principle and Code of Practice for Approved Persons.
93. The provisions as to the corporate governance arrangements are made in FSMA, Sched 1.
94. FSMA Sched 1, Paras 2 and 3.
95. FSMA Sched 1, Para 3.
96. FSMA Sched 1, Para 4.
97. FSMA ss. 2-6.
98. FSMA s.2(3).
99. FSMA s.2(4).
100. FSMA s.2(1).
101. Federal Reserve: Purposes and Functions, Washington, DC, 2005.
102. *www.federalreserve.org*.
103. SEC 2008 Annual Report 8.
104. CFTC Performance and Accountability Report (2008)3.

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