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Best Practices for the Development of Stock Exchanges in Transition Economies

Working Group on Capital Markets Development of the Federation of Euro-Asian Stock Exchanges

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FOREWORD

It is my pleasure to present this set of best practices for the development of stock exchanges in transition economies. It is the result of a joint project between the Istanbul Stock Exchange (ISE), the Federation of Euro-Asian Stock Exchanges (FEAS) and the Organisation for Economic Co-operation and Development (OECD) to support the development and collaboration of stock exchanges in Eurasian countries.

A Working Group from various Eurasian countries was created in 1999 with the mandate to draft a report on best practices for the development of stock exchanges, taking into account the lessons that could be learned from Eurasian countries. This Working Group met several times in Istanbul to discuss successive drafts of the report. The discussions and the resulting report benefited greatly from the insights and experience of policy makers from Eurasian countries as well as experts from OECD countries and various international organisations. As noted in the introduction, securities markets experts from the FIBV (Federation Internationale des Bourses des Valeurs) FESE (Federation of European Stock Exchanges), IFC (International Finance Corporation), CONSOB (Commissione Nazionale per la Societa' e la Borsa), USAID (US Agency for International Development) and other institutions made key contributions to the text.

The report's objective is to assist policy makers and stock exchange officials from FEAS member countries and other emerging markets by providing them with a basic set of legal and market guidelines for the development of stock exchanges. To that end, it sets out 28 Best Practices covering key regulatory and institutional issues related to the operation of stock exchanges. The implementation of these best practices can help policy makers in transition economies to bring stock exchange practices in their financial markets into alignment with global norms and standards.

The recommendations in the report draw on the work of other international forums, including the IOSCO's regulatory and supervisory reports and the FIBV's studies on market best practices.

Recent financial crises in our region and elsewhere, coupled with the ongoing globalisation of markets, have clearly demonstrated that if emerging markets are to be successfully integrated into the world financial system they must have an efficient and robust domestic financial infrastructure that conforms to internationally acceptable standards and best practices. Although many local differences in market structures exist, global standards and best practices are at the heart of the effective development of stock exchanges in any emerging market. One of the report's important goals, therefore, is to build on and complement the various best practices and standards that have been created by international institutions for the development of capital markets.

Following the publication of the report, the next phase of the project will be to assess the implementation of best practices. The focus will be on Eurasian stock exchanges, specifically those from countries of the Members of the Working Group. The primary responsibility for adopting various best practices lies with different entities: regulators, stock exchanges, SROs and the private sector. Supervisory and regulatory responsibilities mentioned in this report are in the hands of regulatory authorities and self-regulatory organisations, in particular stock exchanges. It is envisaged that the Working Group – in consultation with representatives from relevant international organisations and bodies, private sector and other relevant experts – will decide on the appropriate scope of application of these best practices and identify which entities need to be involved in assessing their implementation.

Osman Birsen
President, FEAS
Chairman & CEO, Istanbul Stock Exchange

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INTRODUCTION

This report sets out 28 *Best Practices* to bring stock exchanges in transition countries into alignment with global norms and standards. The discussion benefited greatly from the insights and experience of policy makers from Eurasian countries. Although there may be many local differences in market structures, these Best Practices together form a basis or core for the effective development of a stock exchange in any emerging market.

The report has three main goals. The *first* is to make policy makers in FEAS transition economies more aware of their responsibilities in relation to developing their domestic capital markets. The basic functions of these exchanges are of vital importance to emerging economies. These include capital formation; the channelling of investment funds to the most productive companies; a source of finance for companies; price formation and discovery; and facilitating the growth and efficient trading of securities. Globalisation has meant that emerging financial markets are increasingly shaped by the same business forces as advanced markets. Adhering to international standards and best practices in relation to the development and operation of stock exchanges has therefore become increasingly important in FEAS transition countries and elsewhere.

Its *second* important goal is to assist policy makers and stock exchange officials from transition countries in the development of their stock exchanges. Most emerging market economies adopt a basic set of legal and market institutions as part of capital market development. The basic features of these institutions are often taken from those governing more advanced markets. The next stage in development typically requires the adaptation of these rules to the specific circumstances of the market in question. For this second stage there are fewer ready answers. As

explained in the preamble, a well-functioning institutional infrastructure for stock exchanges consists of a very complex set of rules and market institutions, and its implementation is a very time-consuming process. This report therefore aims to provide general guidance for the adoption and further adaptation of a basic set of legal and market institutions for the development of stock exchanges.

The *third* goal is to build on and complement the various best practices and standards created by international institutions for the development of capital markets. In the aftermath of the financial sector crises of 1994-1995 and 1997-1998, and with the globalisation of markets brought about by rapid changes in technology and communications, two key insights have become widely accepted. First, an efficient and robust domestic financial infrastructure, characterised by the implementation of *internationally* acceptable standards and best practices, is essential for the successful integration of emerging markets into the world financial system. Second, deep and liquid capital markets are vital for the sound development of the overall financial system in emerging economies.

Various international groupings (G-7, G-10, G-20 and others), international fora (Financial Stability Forum, IOSCO and others), and international organisations (International Monetary Fund, Bank for International Settlements, OECD, World Bank, International Finance Corporation and others) have sought to define a range of international best practices and guidelines in key areas to encourage countries participating in the global economy to promote and develop their capital markets. These include work by the Council of Securities Regulators of America on market oversight[1], by the FIBV on market principles[2], by the International Organisation of Securities Commissions (IOSCO) on the objectives and principles of regulation[3], by the OECD on corporate governance[4], and by FIBV, G-30, CPSS, IOSCO and ISSA on clearing and settlement[5]. This report aims to build on and complement their work, with particular focus on devising best practices for the development of stock exchanges in emerging markets.

The report is the result of a joint project between the Istanbul Stock Exchange, the Federation of Euro-Asian Stock Exchanges (FEAS), and the Organisation for Economic Co-operation and Development (OECD), to support the establishment and collaboration of stock exchanges in Eurasian countries. A Working Group from various Eurasian countries was

created in 1999 with the mandate to develop a document on best practices for developing stock exchanges in emerging economies, taking into account the lessons that could be learned from Eurasian countries. The Working Group[6] was supported by a number of experts from OECD countries and relevant international organisations.

Hans J. Blommestein of the OECD Secretariat served as principal drafter to the Working Group. The Working Group is indebted to the following experts who gave comments and provided suggestions in their personal capacity on previous versions of the report: Paul Arlman (Secretary General, Federation of European Securities Exchanges), Dominique Carreau (Professor of Law, University Paris-I, Panthéon-Sorbonne and Consultant, Shearman & Sterling) Tadashi Endo (International Finance Corporation), Gavin Fryer (former Director of Listing, London Stock Exchange), Thomas Krantz (Secretary General, FIBV), Ruben Lee (Consultant to the OECD and Head of the Oxford Finance Group), Salvatore Lo Giudice (Member of the CPSS-IOSCO Task Force on Securities Settlement Systems and Economist in the Market Division, CONSOB), Gerrit de Marez Oyens (Former Secretary General, FIBV), Giovanni Sabatini (Chairman of Working Party 2 of IOSCO, and Co-Chairman of the CPSS-IOSCO Task Force on Securities Settlement Systems; and Head of Market Regulation Office, CONSOB), Aril Seren (Secretary General, FEAS and Senior Vice Chairman, Istanbul Stock Exchange), and Demir Yener (Senior Financial Advisor, United States Agency for International Development).

After the report is published, the next phase of the project will be to assess the implementation of the best practices. The focus will be on Eurasian stock exchanges, specifically those from countries of the Members of the Working Group. Primary responsibility for compliance with the various best practices lies with different entities: regulators, stock exchanges, other SROs and the private sector. Supervisory and regulatory responsibilities are in the hands of regulatory authorities and self-regulatory organisations, in particular stock exchanges. It is envisaged that the Working Group – in consultation with representatives from relevant international organisations and bodies, private sector and other relevant experts – will decide on the appropriate scope of application of the best practices and identify which entities need to be involved in assessing their implementation. Given the scope of the implementation exercise and the composition of its participants, it is proposed that the Working Group develop a specific self-

assessment methodology. This methodology will form the basis for assessing the application and implementation of best practices in developing stock exchanges in Eurasian capital markets.

The structure of the rest of the report is as follows. The Best Practices are divided into seven broad topics: A) Regulation of Stock Exchanges, B) Regulation by Stock Exchanges, C) Institutional Framework for Stock Exchanges, D) Operations of Exchanges, E) Clearing, Settlement, Custody, Registration, F) Issuers, and G) Intermediaries. Each Best Practice is numbered and highlighted in bold, followed by a brief explanation and commentary. They are preceded by a *preamble* that outlines the importance of general legal, regulatory and institutional preconditions for strong securities markets. The problems facing policy makers from transition countries and other emerging markets in developing stock markets are also highlighted. A G*lossary* of technical terms is attached as Appendix I.

PREAMBLE

Strong public securities markets can contribute significantly to boosting economic growth and raising living standards[7]. Recent financial crises in emerging market economies have underscored the importance of deep and liquid capital markets in these economies, and their creation and nurturing have now become a high policy priority. But the development of sound capital markets is a great challenge[8]. The experience of successful capital markets shows that a complex network of legal and market institutions provides the foundation for fair, honest and orderly markets – in other words, market confidence. Confidence in markets cannot, however, be legislated or decreed. The road towards a strong and viable capital market is long and difficult. The implementation of a complex institutional infrastructure takes time. It is very hard, or in many cases impossible, to transplant basic legal and market structures from one jurisdiction to another. For example, honest and competent courts cannot be transplanted. Moreover, confidence is based on reputation and a good reputation (as opposed to a bad one) cannot be established overnight. On the other hand, it can be lost in a minute. The creation of capital markets in Eurasia and other transition countries is therefore a time-consuming process.

Prerequisites for sound capital markets

The importance of confidence and trust in the development of a viable market brings to light two essential sets of prerequisites for any sound capital market[9]:

- Regulations and market institutions to ensure good investor/customer protection. To that end, the market must be fair, efficient, and transparent. The investor/customer must be assured that the rules of the game are fair, equitably applied and effectively enforced.

• Rules and institutions to ensure fair treatment of outside contributors of capital. Investors in public companies, in particular minority shareholders, therefore need to be assured that there is adequate disclosure about the financial condition of a public company, prohibition of self-dealing by insiders (managers and controlling shareholders) to avoid investors being cheated, and providing adequate arrangements for governance and representation.

Major problem areas in transition countries

These two sets of prerequisites form the core of a complex web of legal rules and market institutions needed to create the necessary trust for investors to be willing to hold their savings in the form of shares issued and traded on a stock exchange. The experience of Eurasian capital markets as well as of other transition and emerging markets show that it is very difficult to introduce these prerequisites, and as a result the development of equity markets was much more complicated and slower than expected. Major problem areas include the following[10]:

• As it usually takes a considerable length of time to set up a new company, it is reasonable to expect that the main source of assets to trade will initially come from privatisation. Unfortunately, privatisation took much longer than expected in most countries while capital market involvement was limited or non-existent. As a result, the impact on the growth of capital markets was much delayed and also much lower than anticipated[11]. Even in countries where there was rapid privatisation through mass privatisation methods such as voucher schemes, sound capital markets developed only very slowly or, worse, the use of these privatisation mechanisms had a detrimental impact on the emergence of viable securities markets. This was due to the fact that the privatisation of these assets ran ahead of the implementation of the rules and market institutions that form the foundation for fair, honest and orderly markets. As a result, these privatisations were not subject to the rules, regulations and market institutions for protecting minority shareholders and for preventing self-dealing by insiders[12].

• During the so-called post-privatisation period the development of equity markets in many transition countries was (and is) being hampered

by lack of investor protection and transparent securities trading. Infringements on minority shareholder rights are legion, while investor protection was further weakened by problems with the registration of shares and enforceability of property rights. Serious doubts about standards of fairness and transparency also developed because some transition countries initially adopted a "hands-off" approach to capital market regulation, with woefully inadequate disclosure requirements.

- In some countries there is an entrenched culture of "cronyism" reflected in a high potential for self-dealing. The absence of effective rules, regulations and institutions for controlling self-dealing is a major (perhaps the principal) obstacle to the development of sound equity markets in many countries. There are two major categories of self-dealing[13]. Direct self-dealing concerns situations where the insiders of a company enrich themselves, their relatives, or their friends, or a company controlled by the insiders. Indirect self-dealing (also called insider trading) refers to situations where insiders abuse their information advantage about the company to trade with less informed outside investors.

- In addition to the problem of inadequate or non-existent rules and regulations, there are also serious enforcement problems. Many transition countries lack an effective system for enforcing laws, regulations, and self-regulatory organisation rules governing the operation of equity markets.

Clearly, this list is not exhaustive, but it highlights the principal problems encountered in trying to develop strong capital markets in Eurasia and other transition countries. Other obstacles faced by policy makers in transition countries include: low quality or inconsistent accounting standards; poor or non-existent corporate governance standards; lack of investor compensation schemes; insufficient knowledge of basic capital market rules and practices among investors; a weak bankruptcy system; no rules for take-overs; the absence of large and active domestic institutional investors; inadequate clearing and settlement systems; the need to establish a simplified tax regime for securities[14]; grey areas of legislation due to inconsistencies in the legal and regulatory framework; the absence of (modern) legislation for the operation of contractual savings entities; lack of competition in domestic financial markets, specifically the dominance of the banking sector in many countries.

Major elements shaping the policy agenda for the development of stock exchanges

These problem areas, and the two essential sets of prerequisites mentioned above, define a challenging policy agenda for the development of stock exchanges. The key elements of this agenda for policy makers in transition countries and other emerging markets are:

An adequate legal framework for the effective regulation and functioning of exchanges

The introduction of an appropriate legal environment is necessary for the proper regulation and functioning of stock exchanges (in essence this environment provides a supporting framework for the rules, regulations and operations of the exchanges themselves). Emphasis should be placed on the following considerations. *Company laws* should contain a comprehensive legal regime applicable to all securities (i.e. bonds, shares, hybrids, derivatives) as well as to public corporations (i.e. those engaged in public offerings) with the main objective being the protection of investors in general, and minority shareholders in particular. Company law should also include proper *take-over regulations*[15] that would make sure that all bids have fair terms (and, therefore, respect the equal rights of shareholders), are transparent and open to competition; moreover, legal thresholds that would trigger mandatory bids or permit buy-outs of minority shareholders should be determined.

A proper *criminal financial law* should be adopted to prevent or punish effectively illicit transactions that would endanger the fair and orderly functioning of stock exchanges. This includes the prohibition of direct and indirect self-dealing (insider trading), market manipulations, and spreading misleading information.

For example, according to IOSCO[16], an appropriate legal framework for effective securities regulation should include the following: commercial code/contract law (property rights, private right of contract, etc); bankruptcy and insolvency laws; competition law; banking law; modern and consistent taxation laws; dispute resolution system (a fair and efficient judicial system, enforceability of court orders and arbitration awards)[17].

Competition and balanced capital market regulation

Regulation should be effective, that is, ensure that the three core objectives of regulation are achieved: the protection of investors; the operation of fair, efficient and transparent markets; and the reduction of systemic risk. In addition regulation should be "balanced", that is, compatible with open and competitive capital markets. The following criteria and considerations can be identified[18]. Capital markets should be open to all participants who meet the specified entry criteria (i.e. no unnecessary barriers to entry and exit). The regulatory authorities should consider the impact of the requirements imposed and subject them to cost and benefit calculations. There should also be fairness and equality of the regulatory burden. The regulatory authority's oversight of the exchange should make certain that exchange rules and procedures are in the public interest and are not anti-competitive[19]. The regulator must also ensure that the environment of the exchange is fair (that is, open and competitive) and that customer orders are treated accordingly[20].

Against this backdrop, there has been a fair amount of debate on competition between exchanges and the related role of new information and communication technologies. The extent and manner of the competition between securities markets will depend on how effectively those markets service orders directed to them, and how cost-effective transaction execution is. Some transition countries have sought to ensure that only one major exchange is in operation, or to restrict the trading of shares in companies that are listed on another exchange[21]. It is unlikely that these policies will be successful in the long term in shielding a market from diversification and competition. Ultimately, both firms and investors will benefit from increased competition within and between markets.

More recently, the development of access via Internet routing is permitting investors to trade through web-sites, in some cases directly with each other, bypassing traditional exchanges. Some securities business that was traditionally conducted on-exchange may migrate off-exchange. The regulatory bodies of capital markets have an important role in ensuring that there is competition between market intermediaries in order to prevent collusion, and that market infrastructure costs are fairly distributed. Although these issues already figure high on the agenda of policy makers from the more advanced markets, they are becoming increasingly important to those from transition countries and other emerging markets.

Effective oversight and enforcement

Fair, honest and orderly markets require effective oversight. Effective oversight entails the following three key components[22]: 1) a framework for the development of sound capital markets as well as for imposing responsibility and accountability on market participants; 2) a framework for monitoring compliance with statutory and self-regulatory regulations; 3) an effective system of enforcement. After authorisation by the regulator, self-regulation by the stock exchange and other SROs can be an efficient mechanism for overseeing the activities of market intermediaries and market operators. Ongoing oversight of the exchange (and other SROs) by the regulatory authority is critical to guard against conflicts between industry self-interest and the public interest (e.g. the use of anti-competitive exchange rules).

Monitoring compliance with laws and regulations involves three elements[23]: *a*) market surveillance (monitoring day-to-day trading activities), *b*) examination of market intermediaries, and *c*) analysing the findings from *a*) and *b*). The exchange is usually involved in monitoring compliance. The regulatory authority therefore has to determine the scope of this monitoring function and verify the integrity and effectiveness of the exchange's oversight system on an ongoing basis.

Another important pillar of effective oversight is enforcement. The regulator or other government authority (e.g. a prosecutor) should be provided with comprehensive investigatory and regulatory powers. These include the power[24]: to obtain information, documents and records from persons involved in or relevant to the enquiry; to seek orders or to take other action; to impose administrative sanctions or to seek orders from courts; to initiate or refer matters for criminal prosecution; to order trading halts or other actions; to enter into enforceable settlements and to accept binding undertakings.

An effective enforcement programme requires adequate resources and highly trained investigators. Both requirements are problematic in many countries in Eurasia and elsewhere. The complex character of capital market transactions and the sophistication of many fraudulent schemes require highly skilled and specialised investigators, judges and courts. Unfortunately, funding problems and lack of qualified and specialised staff often weaken effective oversight in Eurasia and other transition countries.

Experienced regulators/supervisors/prosecutors/judges need to be paid a competitive salary, otherwise they are likely to defect to the private sector. The risk of corrupt conduct (including accepting bribes) also increases. Thus, supervisory activities need to be sustained by adequate budgets for salaries, education, computer systems, etc. Strong enforcement also requires a sophisticated and honest judiciary system that can intervene quickly (e.g. to prevent asset stripping) and produce decisions within a reasonable timeframe. In many transition countries shortcomings in this area also result in serious bottlenecks.

The vital role of disclosure for protecting investors

Rules for full disclosure of information relating to investor's decisions are the most important way of protecting investors against: fraudulent schemes; market manipulation; and other manipulative practices, including self-dealing, front running or trading ahead of customers, and the misuse of clients' assets[25]. High disclosure standards, based on accounting and auditing standards that are of internationally acceptable quality, are needed to deter or reduce direct and indirect self-dealing in transition countries[26]. Another issue concerning disclosure requirements in transition countries is so-called "merit based" regulation. IOSCO argues that merit based regulation – in which the regulator takes some responsibility for assessing the quality of a proposed offering – might be useful where a market lacks a group of analysts and advisors for analysing information when it is being disclosed to the public[27]. As this issue is related to the market development stage, it is generally regarded as transitional.

Disclosure rules need to be supported by laws that prohibit insider trading and mandate extensive disclosure of direct self-dealing transactions. Effective supervision is vital for enforcing high disclosure standards.

The importance of reputational intermediaries[28]

In addition to the complex web of laws, regulations and supervisory procedures for the development of sound capital markets, key market institutions such as reputational intermediaries[29] are a critical factor. These include accounting firms, securities firms, investment banks, law

firms, rating agencies and stock exchanges. The main capital market function of these intermediary institutions is to vouch for the quality of particular securities on the basis of their reputation[30]. In carrying out this function they are an important element in creating a strong framework for protecting investors. For example, many investors rely on financial statements to be audited by a reputable accountant, shares to be underwritten by reliable investment bankers, the prospectus to be drafted by an honest securities counsel, companies to be rated by objective rating agencies and new issues to be listed on a reputable stock exchange.

The value of honest intermediaries with a sound reputation can be diminished by the operations of "bogus" or dishonest intermediaries. This is a recurrent problem in transition countries, but it also occurs in the more advanced markets, although less severely. In fact, dishonest intermediaries can tarnish the reputation of whole classes of intermediaries. For this reason several reputational protection arrangements should be established, including licensing procedures, membership criteria of self-regulatory organisations, and oversight and sanctions by regulators and SROs.

The role of corporate governance standards

In addition to a strong regulatory framework, effective oversight and reputational intermediaries, sound corporate governance practices are also very important for safeguarding the interests of shareholders (including minority shareholders)[31]. Governance rules that stipulate the duties of directors (including the independent ones) are important for inspiring the confidence of outside investors[32], for example, by having independent directors and/or non-interested shareholders review major self-dealing transactions. This can be an important additional procedural protection on top of disclosure rules, especially in transition countries[33]. Corporate governance standards are usually addressed through statute or exchange listing rules or code of business practice. It is important that countries and companies indicate and publish what kind of governance rules and practices they adhere to.

In view of the growing recognition that governance standards are important for open, competitive and well-functioning markets and companies, the OECD has promulgated international principles of corporate governance. The Principles represent a common basis that OECD Member countries consider essential for the development of good governance practices[34].

Best practices for developing stock exchanges

Against the backdrop of this policy agenda, this report sets out 28 Best Practices for aligning stock exchanges in emerging financial markets with global norms and standards. As mentioned in the Introduction, the Best Practices form a basis or core for the effective development of stock exchanges in transition countries and other emerging markets. Compliance with internationally recognised best practices has become more important in recent years. National markets are increasingly inter-linked, thereby widening the externalities associated with the conduct of national economic and financial policies. The greatly expanded size of international capital flows dwarf those of international trade and as a result the transmission of shocks is likely to be quicker than in the past. Consequently, the importance of a modern and strong financial infrastructure has increased. Last, but not least, there is a growing emphasis on private markets. This has highlighted the importance of sound policies and other factors for the efficient functioning of private markets, in particular strong domestic financial markets.

Financial policy makers around the globe have recognised that the implementation of internationally acceptable standards and best practices is essential for the successful integration of transition countries and other emerging markets into the world financial system. Policy makers from emerging markets increasingly appreciate the importance of strong domestic capital markets for economic growth and higher living standards.

Clearly, this list of 28 best practices is not exhaustive. It does, however, capture the main policy areas for developing stock exchanges. It is also important to emphasise that there is no "one-size-fits-all" model of regulation, supervision, etc. There is no single correct approach to many of the policy issues covered in this preamble and listed in the best practices. Legislation, regulatory and supervisory arrangements vary between jurisdictions with different legal traditions. Differences also reflect local capital market conditions (financial resources, available human capital, etc.) historical development (a very significant factor in the transition countries), culture and other informal institutions. However, the best practices set out in this report represent a set of internationally desirable or acceptable standards that aim to provide guidance for the development and implementation of policy irrespective of local differences; together they form the basis for the development of sound stock exchanges in transition countries and other emerging markets.

REGULATION OF STOCK EXCHANGES[35]

The Framework for Securities Market Regulation and the Regulation of Stock Exchanges

BEST PRACTICE 1

The development of securities markets requires appropriate laws and regulations governing: the raising of funds on capital markets; the operation and integrity of intermediaries, the exchanges themselves, and after-trade service systems (including securities settlement systems); the operation and integrity of corporations; the protection of investors; and the fair treatment of outside contributors of capital including the prohibition of self-dealing and safeguarding shareholders' rights.

A framework of well-functioning laws and regulations governing the enforcement of contracts, insolvency, and the protection of property rights, is essential to the fair and effective operation of a stock exchange. Transparent and efficient laws and regulations should be designed to achieve three core objectives of securities regulation[36]: protection of investors; assurances that markets are fair, efficient and transparent; and the reduction of systemic risk, taking into account international standards. The web of relationships between the many participants in capital markets needs transparent regulation and an established code of legislation and legal practices. Such a legal framework would include company law, securities law and supporting legislation on such matters as authorisation to provide financial services, disclosure of information and the protection of investors. Properly functioning securities markets also require an effective and coherent legal, tax and accounting framework[37]. The licensing and monitoring of market participants – including the members/owners of the exchange and other intermediaries – should be performed with clear and equitable criteria and licensing procedures, taking into account the IOSCO principles on

the licensing authority and licensing process[38]. The stock exchange itself must be regulated and supervised in accordance with internationally acceptable principles for self-regulatory organisations (SROs)[39]. A comprehensive legal framework for securities markets includes rules and regulations for securities settlement systems[40], registry, depository systems, and custodial and transfer agent services. Collective investment schemes of all types also need to be regulated. In addition, the various laws and regulations should permit sanctions and enforcement mechanisms and arrangements for dealing with complaints and disputes, as well as other appropriate legal procedures including arbitration.

Allocation of Regulatory Powers

BEST PRACTICE 2

The allocation of the power to regulate should be clearly specified.

In many jurisdictions the power to regulate is the shared responsibility of two or more government or quasi-government agencies, and may include a securities market commission. The powers and responsibilities of the regulator must be transparent, objectively stated and together cover the entire area to be supervised without inappropriate gaps or overlaps. The stock exchange – to the extent that it is accorded self-regulatory powers – becomes an integral part of the regulatory regime.

The stock exchange as a self-regulatory organisation should be authorised by the regulator and subject to the oversight of the regulator on an ongoing basis. Within this regulatory framework, the power to make rules can be allocated between the legislature, governmental agencies, and self-governing organisations in such a way that public confidence is inspired and maintained while also allowing sufficient flexibility to adapt to new circumstances in capital markets.

The regulatory agency or securities commission should be independent and accountable, with sufficient inspection and enforcement authority to have effective oversight of market participants, including SROs such as the stock exchange. The actual balance between statutory regulation and self-regulation may differ between countries, depending among other things on market structure (size and complexity), experience, and tradition[41]. A critical concern should be to avoid overlapping jurisdictions.

Authorisation and Competence of Stock Exchanges

BEST PRACTICE 3

A stock exchange should be established with sufficient capacity to undertake the responsibilities for building and maintaining the integrity of a fair market.

As a condition to granting an exchange authorisation as an SRO, the regulator should require the stock exchange to have the capacity (authority, expertise and resources) to carry out the purposes of governing laws, regulations and stock exchange rules, and to enforce compliance by its members, shareholders and associated persons with those laws, regulations and rules[42]. This capacity should enable a stock exchange to sustain the integrity of the market. A stock exchange should be empowered to evolve its equitable rules and standards beyond mere statutory requirements or the level of regulation specified by the supervisory body, without unfairly restricting competition. An important example is the observance of ethical standards that go beyond government regulations.

Responsibilities of Stock Exchange and Ongoing Oversight by the Regulator

BEST PRACTICE 4

A stock exchange has a front-line obligation to develop standards of proper business behaviour (including compliance and disclosure) for: *a)* its own members or shareholders; *b)* listed companies; and *c)* the issuing process. These standards are subject to review and/or approval by the regulator. An exchange also has the responsibility to co-operate with the regulator and other SROs to maintain the integrity, fairness and soundness of the market.

The SRO role of a stock exchange serves as a valuable complement to the regulator. Stock exchanges, being part of the regulatory regime, have an important front-line responsibility to develop rules that are designed to set and enforce business standards that are essential to the maintenance of the integrity of the market. The fulfilment of this responsibility is supervised on an ongoing basis by the regulator. These rules should be submitted to the regulator for review and/or approval, as the regulator deems appropriate[43]. It is also essential that stock exchanges work closely together with the regulator and other SROs in the market to investigate and enforce applicable laws and regulations.

REGULATION BY STOCK EXCHANGES

Transparency of Stock Exchange Rules

BEST PRACTICE 5

The rules and regulations of the stock exchange should be clearly expressed, understandable and readily available to anyone who needs to use them.

All regulatory or oversight powers of the exchange should be founded on legislative provisions. Based on this, a distinction can be made between activities that are regulated by laws/statutory regulation (usually the core market functions of an exchange) and those activities that are managed on a contractual basis (e.g. selling trade data to information vendors), subject to review and/or approval by the regulator[44].

Market operations should be guided by rules that are founded on well-established practices that are widely understood, clearly expressed and readily available to anyone who needs to use them. The rules of a stock exchange must be applied equally to all participants without favour or discrimination. The stock exchange should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities[45].

The regulator should assure itself that the exercise of the self-regulatory power by the stock exchange is in the public interest, and results in fair and consistent enforcement of applicable securities laws, regulations, stock exchange rules and the corresponding rules of other SROs[46].

Rules are needed for a wide diversity of activities: admission to trading; listing; integrity and conduct in the market; service providers to the market; relationships with customers; complaints, procedures for disputes,

arbitration and discipline. Rules will also be needed to ensure a high standard of conduct in the following fields: licensing; surveillance; enforcement and discipline; standards of integrity for broker-dealers and other market participants; conduct of business of firms.

Stock Exchange Rules and Due Process

BEST PRACTICE 6

Rules and regulations established and decisions taken by a stock exchange should be fair, equitable and subject to review.

The rules of a stock exchange must be applied equally to all types of participants without favour or discrimination. The stock exchange should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities[47]. The regulator should assure itself that the exercise of self-regulatory power by the stock exchange is in the public interest and consistent with open and competitive markets[48], that it results in fair and consistent enforcement of stock exchange rules[49] and that it does not impair fair and effective enforcement of securities laws, rules and regulations.

Surveillance, Enforcement and Compliance by Intermediaries and Listed Companies

BEST PRACTICE 7

The exchange must have adequate procedures and powers for gathering the required information for surveillance, compliance and enforcement purposes.

The stock exchange (in its SRO capacity) will monitor intermediary firms for their market activity. For this to be done effectively, the firms have to subject themselves to the stock exchange's membership rules by applying for access to the central pricing mechanism, after having obtained a license to conduct securities business. In cases where an intermediary firm does not hold an up-to-date and unqualified licence to conduct securities business, the firm should be suspended from trading on the exchange. Effective enforcement and compliance require that the firm's directors, officers and employees adhere to the market rules and guidelines. To that end, the

directors, officers and employees of intermediaries shall be obliged to supply information to regulatory bodies upon request; attend meetings when required to do so; and answer any questions by giving complete and truthful replies on any aspect of the firm's business[50].

The regulator should assure itself that the exercise of these powers by the stock exchange is in the public interest, and results in fair and consistent enforcement of applicable securities laws, regulations and exchange rules.

Monitoring of Trades

BEST PRACTICE 8

The stock exchange system should record all trades and capture order entry data for surveillance purposes.

The monitoring of trades includes recording the activities of intermediary firms and listed issuers. When the stock exchange has a thin market to monitor, particular care should be taken against manipulation. Relatively illiquid markets may be more likely when there are few players (such as in many emerging capital markets) than when stocks are frequently traded by a significant number of competing market makers. The exchange should establish day-by-day monitoring of trades and price formation. It must note exceptions to usual patterns of dealing, and keep track of the identity of key active participants such as directors of public companies and other insiders or persons with access to non-public information. The trading records should be designated to permit the reconstruction of trading activity and be kept for many years.

INSTITUTIONAL FRAMEWORK OF STOCK EXCHANGES

Constitution and Organisation

BEST PRACTICE 9

The stock exchange should establish membership rules as well as rules concerning the organisation and operation of the exchange within the limits of the statutory legal framework. The regulator should ensure that these exchange rules are in compliance with general laws and monitor their enforcement.

The structure of a stock exchange should allow for the creation of an orderly and transparent forum for the purchase and sale of securities by market participants, including member-intermediaries (in the case of a mutual structure), owner-intermediaries (in the case of a for-profit structure), other broker-dealers, investors and issuers. The stock exchange provides the infrastructure for trading securities in the secondary market.

Constitutional and organisational issues that need to be addressed include the question of the exchange's legal status and whether it should have statutes. How should its membership or ownership structure be organised? Which organisational infrastructure is appropriate, and what amount of financial resources would be considered as adequate? Which infrastructure is needed to monitor market participants?

Ownership and Business Model

BEST PRACTICE 10

Exchanges should be free to choose their own business model, to compete for business and to set their own commercial agenda. This should be done within the regulatory framework to protect the public interest.

Supervisors and regulators should allow an appropriate diversity of ownership structure possibilities, domestic and international alliances, and technological linkages. Where a stock exchange has been established by the state and an initial amount of capital has been provided from central government funds, the question of ownership may not arise. Members may own the exchange in the form of a mutual organisation, sharing in the costs through tariffs set to absorb them. A number of stock exchanges, largely in the OECD area, have decided or are coming round to the view that they should be fully commercial entities with external shareholders.

Financing

BEST PRACTICE 11

Revenue flows should be sufficient to pay for operating costs and fund future development.

Services and listing fees normally represent more stable, though more limited, sources of income than trading and other revenues (income from IT system sales, proceeds of financial investment, fines imposed by exchanges, and rent from stock exchange properties). To achieve this, tariffs need to be structured to equate with the market operator's expected financial objectives. As in any enterprise, a proper return on risk capital must be calculated.

Forward planning must also ensure that funding for development of the market is available when required. Some countries may wish to consider whether there should be a "trust fund" and capital arrangement by which additional funding can be obtained to recruit the skilled staff needed to perform impartial, unbiased regulatory work.

OPERATION OF STOCK EXCHANGES

Trading System

BEST PRACTICE 12

Each securities market must decide on the system(s) of trading to be used by market participants.

Two basic trading systems can be distinguished: the "order driven" system in which prices are driven only by actual orders from customers via their brokers, and the "quote driven" system via price quotations that dealers calculate from the orders that they might expect to come to the market. Nowadays most markets use hybrid systems based on a public order book. Full information about the type of trading system used (continuous and non-continuous trading), and the order execution algorithm commonly used during opening, closing and call auctions (i.e. the set of rules determining how quotes get translated into trades) should be made public.

Cross-border trade increases the importance and complexity of certain issues, including legal and risk issues in settlements as well as in regulation and oversight[51]. Arrangements for cross-border trading should be clearly specified by the market authority[52] and implemented by the exchange and other actors. Participants from outside the jurisdiction of the market should be bound by the rules of the market.

Once orders have been matched with the prices available from market makers, or with other orders placed with the central order book, trading is executed. Firms must then report back to their customers, so that the next steps in after-trade processing can be taken. Following every trading operation a contract note is issued to customers on each side of the transaction.

Market Transparency

BEST PRACTICE 13

Information about trade execution, prices and quotes should be made public as soon as possible and in accordance with the rules of the market and the competent regulatory authority.

IOSCO defines transparency as the degree to which information about trading (both information on pre-trade and post-trade activities) is made publicly available on a real-time basis[53]. A stock exchange must provide a fair and transparent market by monitoring and demonstrating the fairness of the price discovery process.

Timely access to relevant information about secondary trading allows investors to protect their own interests more effectively. It also reduces the risk of unfair trading practices. Increased market transparency also benefits the management of listed companies. Transparency can be supported by publishing the statistical highlights of trades, prices, aggregate volumes and values of the day's turnover of securities on the business day following each trading session. Information must be readily available to all market participants, and definitions of data clearly noted[54].

The market authority (being either or both the exchange operator and the regulator) should have access to the complete order information, whether executed or not, to be able to assess the need for derogation[55] from the objective of real time transparency and, if necessary, to prescribe alternatives.

The Media and Public Opinion

BEST PRACTICE 14

The managers of a stock exchange should have a clear understanding about their public roles and functions, and how these are perceived. These must be articulated clearly to companies, investors and representatives of the media.

The media and public opinion can be influential in affecting the activities of stock markets (including trading and listing). The management of a

stock exchange, the supervisory activities of the exchange, and issuers of securities traded on the market may all be the subject of reports by the media. These reports can have a crucial impact on the perceptions of investors and the public at large of the effectiveness and fairness of the market, and on the future development of the business of an individual issuer. It is therefore in the interest of stock exchanges' senior management to articulate clearly their role and objectives to public companies and investors and dispel any misinformation. In order to attract new listings and investors it is important that both the management of companies issuing securities and investors have a good understanding of the objectives and role of a stock exchange as well as the operation and control of securities markets. It is also desirable that representatives of the media have a proper understanding of the role and objectives of a stock exchange. They should appreciate why rules are applied, and be aware of the possible consequences of misreporting news.

CLEARING, SETTLEMENT, CUSTODY, REGISTRATION

BEST PRACTICE 15

Clearing, settlement, depository, custodial and registration services provided by the stock exchange, its subsidiaries or others must be fair, effective and efficient and support the secondary market. All trading should be cleared and settled according to internationally accepted standards.

Basic Conditions for Effective Clearing, Settlement, Custody and Registration Services

Key conditions in designing fair, effective and efficient systems for clearing[56], settlement[57], depository, custodial and transfer agent registry[58] services should include the following:

Legal Framework

Reliable and efficient securities settlement systems (including clearing, settlement, custody and registration services[59]) require an adequate legal framework that is consistently applied[60].

Finality of Trades and Settlements[61]

Final settlement means the discharge of obligations by a transfer of funds and a transfer of securities that have become irrevocable and unconditional.

Reliable Recording of Trades and Trade Confirmation

All transactions must be recorded and confirmed as soon as possible after trade execution. There must be certainty in each transaction, with all

relevant information being confirmed, including the identity of the security traded, the identities of the counterparties, the quantity, the price, and time and mechanism for settlement. Increasingly, automation is being used for the matching and confirmation of trading transactions, thereby improving processing times and avoiding the errors inherent in manual processing.

Unrestricted Transfer

There should be no restrictions placed on the free transfer of securities between buyers and sellers other than the imposition of restrictions on free transfer placed by securities market regulators or, in exceptional circumstances, by a court order.

Dematerialisation and Central Securities Depositories (CSD)

Dematerialisation occurs when an electronic form of record of title to securities, instead of a paper certificate, is held in an account to represent the holding of securities. The agent holding the accounts normally provides a statement of ownership concerning this electronic form of record to the beneficiary from time to time. This is usually distinguished from a physical document of title in the form of bearer certificates[62]. The record of a book entry will look to some extent like a bank account statement.

The dematerialisation of securities and their transfer by book entry within a CSD includes many benefits[63]: lowering the costs associated with securities settlement and custody[64]; improving the speed and efficiency of settlement[65]; eliminating the risk of theft or destruction of bearer certificates; increasing the transparency and legal robustness of custody and transfer arrangements; and reducing tax evasion. Dematerialisation is a precondition for shortening settlement cycles and facilitating the adoption of DVP. A CSD supports the development of securities lending markets[66].

It is essential that CSDs commit adequate resources and capabilities to risk management. Governance arrangements for CSDs should be carefully designed to protect both the private interests of the owners of the facility, the users and the public interest[67].

Clearing and Settlement

Settlement of transactions should be undertaken according to internationally accepted standards, including the G30 standards[68] and the updated and expanded recommendations by the CPSS-IOSCO Joint Task Force on Securities Settlement Systems[69]. Clearing and settlement of securities involves the following three basic steps: *i)* trade confirmation; *ii)* clearance; and *iii)* settlement. There are important additional services that have a significant impact on the reliability and efficiency of the clearing and settlement process. The efficiency of registrars determines the ease with which full legal title to securities can be transferred, which in turn has an influence on the speed of settlement. Clearly, settlement cannot be finalised until registration is complete[70]. While securities are held in book entry form by CSDs[71], many owners of securities are not members of a CSD. These owners need to establish safekeeping or custodial relationships[72] with members of CSDs. The entities holding securities in custody should employ internationally accepted practices and procedures to protect customers' securities fully[73]. A key procedure to protect customer securities in the event of the custodian's insolvency is through segregation[74].

High standards for settlement ensure that every customer who has sold securities promptly obtains the proceeds of the sale. Buyers must be able to obtain title to the securities purchased so that at any time there after sales of some or all of that stock will be settled promptly by delivery of the title held by the seller.

An issuer must not prevent a buyer of securities from obtaining unimpeded title by refusing to register the securities in the buyer's name. The evidence of the buyer's title must be issued to him or his agent promptly following the trade. Accurate recording of new buyers' identities and expeditious settlement of trading transactions is therefore essential to market integrity.

Improved technological methods, such as straight-through processing (STP[75]), is helping to reduce settlement cycles in some markets and bring them closer towards same-day settlement. This will have a significant benefit on trading, and also minimise the risk of an intermediary becoming insolvent during a longer settlement period. The reduction of settlement cycles to T+3 or less (T+2) will therefore assist in the process of building

and enhancing the public's trust in the market. However, when the reduction of settlement cycles beyond T+3 is not supported by the necessary investments and upgrading in the market infrastructure, it will result in an increase of failed transactions. For each market, therefore, both the benefits and the costs of any further reduction of the settlement cycle should be assessed[76].

International Standards

The Working Group recommends the implementation of the standards promulgated by the G30, FIBV and ISSA, and in particular the recent work done by IOSCO and CPSS. They include the following, in which "T" refers to the day of a stock exchange trade:

Efficient Trade Comparison and Confirmation

All comparisons and confirmations of trading between direct market participants (primarily broker-dealers) should be accomplished by T+0. The comparison and confirmation of trading involving indirect market participants (such as institutional investors and cross-border clients) should be accomplished as soon as possible, preferably on T+0, but no later than T+1.

Central Securities Depository (CSD)

Securities should be dematerialised (or, at least, immobilised[77]) in CSDs to the greatest extent possible, in particular the holdings of the most active market participants.

Possibility of Netting

Netting refers to the agreed offsetting of positions or obligations by market participants, leading to a reduction in the amount of processing or the levels of exposure in settlement systems. Netting reduces a large number of individual positions or obligations to a smaller number of positions and net obligations, thereby leading to the lowering of risks. Netting with novation and real time gross settlement can be efficient settlement

mechanisms[78]. Netting benefits can also be achieved using a central counterparty. There is a growing demand for central counterparty arrangements in many jurisdictions, in part reflecting the increasing use of anonymous electronic trading systems. The regulator and market participants should study which arrangement is best suited to their marketplace for reducing risk and promoting efficiency[79].

Delivery versus Payment and Settlement Finality

Delivery versus payment (DVP)[80] should be the standard method for settling all securities transactions. This ensures the elimination of principal risk. Different models of DVP can be distinguished, depending on whether the securities and/or funds transfers are settled on a net or gross basis, and on the timing of final transfers (next day, end of day, intra-day or real time)[81].

Rolling settlement

The market authority in all securities markets should adopt a “rolling settlement” system[82]. The minimum intermediate standard for final cash settlement is T+3, and the net benefits of a shorter settlement should be investigated.

Securities Lending and Borrowing

Securities lending and borrowing should be encouraged as a method of expediting the settlement of securities transactions. Legal, banking, regulatory, taxation and other barriers to the development and functioning of securities lending should be removed. The counterparties to securities loans should employ appropriate risk management procedures[83].

Standards for Securities Messages

Each country should adopt the standard for securities messages as formulated in the “data dictionary”. This family of standards replaces the standards developed by the International Organisation for Standardisation, notably the ISIN numbering system for securities issues.

ISSUERS

Companies wishing to raise funds through an issue of securities may do so in one of two ways. They may make a private offer to identified parties (a private placement) or an offer of securities to the wider public via an exchange. Regulation of public offers should ensure a fair, orderly and efficient market and a high level of investor protection. To meet these ends, initial disclosure in the offering prospectus must be followed by timely and ongoing disclosure of material information. The regulator should set disclosure rules covering, *inter alia*, the conditions related to the public offering of securities; the content and distribution of prospectuses; supplementary documents prepared in the offer; advertising related to the new issues[84].

An exchange has an important role to play in requiring adherence to these disclosure rules, standards and procedures. More specifically, exchanges should require the timely and widest possible disclosure of business and financial information materially affecting listed companies as well as regular disclosure of financial information by listed companies[85].

Listing Rules

BEST PRACTICE 16

The Regulator and the Exchange should formulate and publish appropriate listing rules. The respective responsibilities of the Regulator and the Exchange in the listing process should be fully transparent.

Listing rules are key for controlling the standard of disclosure and code of conduct of companies offering public securities. Listing rules are to be reviewed and approved and standards[86] monitored by the regulator. In

cases where the regulator and the exchange share listing responsibilities, it should be completely clear for market participants where each step in the decision-making process lies, including the ultimate decision in the listing process.

Listing requirements specify the relationship between the exchange and the issuer, and govern the standards expected of the issuer and its directors. The regulator and the stock exchange together define the responsibilities and obligations of the listing company in connection with the trading of their issued and outstanding securities in the listing market[87]. Requirements such as the listing procedures, time scheduling for processing of the listing dossier, costs for the issuer[88], and minimum size of capitalisation, should be compiled in a single rulebook, which should be publicly available[89].

Issuers and Ongoing Disclosure

BEST PRACTICE 17

Material information about corporate events and actions must be disclosed to the public on an ongoing basis, and made available as soon as is feasible.

Issuers must keep investors informed on an ongoing basis, largely through periodic financial statements, but also by announcing events and actions that have a material effect on corporate value. In this way, investors and intermediaries are able to assess factors that contribute to the price discovery process, and make informed decisions as to whether they should deal.

Disclosure to investors should include, but not be limited to, material information on: financial and commercial results; company objectives; major share ownership and voting rights; members of the board, key executives, and their remuneration; material foreseeable risk factors in the company set in the context of its industry; material issues regarding employees and other stakeholders; and governance structures, policies, and implementation thereof.

Considerations and issues related to the disclosure of *financial* information include the following: the information needed for the “due diligence process” applied to listed companies; procedures on how the public and

the regulatory bodies can obtain disclosure from issuers, beyond the minima specified in national company law; the process needed for information to be made available to the public by issuers; the issuer's responsibility for compliance with the standards of disclosure; a statement of continuing obligations that provides a framework for issuers to fulfil their duty to the investing public by keeping the market fully informed at all times; the basis on which issuers are bound to observe continuing disclosure obligations[90].

Stock exchanges have an important role to play in ensuring that companies adhere to high quality standards of financial disclosure. Comparability and reliability of financial information are critical to informed decision making. The exchange should therefore require issuers to prepare their annual accounts in accordance with high quality standards for accounting, including those promulgated by international organisations such as the International Accounting Standards Committee (“IASC”), the International Organisation for Securities Commissions (“IOSCO”) and other organisations.

However, effective financial reporting is not solely the product of high-quality accounting standards. What is also needed is a high-quality financial reporting infrastructure[91]. The exchange should also require the use of auditing procedures based on standards of a high and internationally acceptable quality. The regulator should ensure that a mechanism is in place to enforce compliance with accounting and auditing standards.

The OECD Principles of Corporate Governance specify the disclosure and transparency standards of an effective framework for corporate governance of listed companies. They also stipulate that information should be prepared, audited, and disclosed in accordance with high quality standards of accounting, financial and non-financial disclosure, and audit. An independent auditor should conduct an annual audit.

BEST PRACTICE 18

The stock exchange should have the authority to require ongoing and event-driven disclosure for listed companies, in order to address any new or particular corporate activities or developments. This is a front-line regulatory responsibility that enables the exchange to ensure the quality of the market it operates, subject to ongoing oversight by the regulator.

This front-line role of the exchange means that it should have the authority to make timely changes to disclosure rules. Changes may be triggered by the desire of issuers to take advantage of new developments and circumstances and the exchange's wish to obtain additional disclosure for the investing public. Changes in rules or additional requirements should be published in advance of their application, so that the issuer and its advisers can take them into account in preparing the prospectus.

Disclosure procedures for public companies approved by an exchange for the trading of their securities can be divided into three parts:

a) a first prospectus written at the time of the initial public offer of shares or other securities;

b) the publication of a further prospectus or other equivalent document or circular to existing shareholders and third parties; and

c) continuing disclosure to shareholders and the public.

Initial Public Issues and Prospectuses

BEST PRACTICE 19

Investors must be able to make an informed assessment of present and prospective assets, liabilities, financial position, profits and losses, the commercial prospects of the issuer of the securities, and the rights attaching to those securities. A comprehensive report (prospectus) that covers these matters must be made available well before the offer.

The overall picture of an issuer is presented for the first time in a prospectus in support of its initial listing that makes full disclosure. Preparation of an initial prospectus involves the banks, the regulator and the exchange in assessing the suitability of the issuer and its securities for public offer. It is vital that the prospectus contains all the information that investors and their professional advisers would reasonably expect to find. Accounts that comply with internationally accepted accounting and auditing standards facilitate understanding and allow international comparisons of companies in the same or similar businesses.

Privatised Companies

BEST PRACTICE 20

The listing authority must ensure that if the government still holds a shareholding in a listed security, it is held to the same standards as other investors, and has no advantages over them.

The government may partially or completely privatise some companies while effectively maintaining direct or indirect control of them. In such circumstances, there must be measures in place to ensure that other (including minority) shareholder rights are not abused.

Sanctions and Penalties for Listed Companies and Directors

BEST PRACTICE 21

The stock exchange should have at its disposal a range of sanctions and penalties to deal with listed companies and directors whose actions may diminish market integrity and investor trust. These sanctions and penalties should be used in a proportionate manner, and should be subject to review and appeal via a fair and equitable procedure of due process.

As part of its self-regulatory duties, a stock exchange may typically have at its disposal the following sanctions and penalties against listed companies and directors: *1)* private criticism; *2)* public statement of the facts, with or without criticism; *3)* temporary halt at the issuer's request, provided that the exchange understands the circumstances in which, and the time within which, trading can be expected to resume (during the halt the issuer is required to prepare and publish a statement containing additional or previously missing information); *4)* temporary suspension of trading with an explanation to the market by the stock exchange; *5)* cancellation of listing following which the issuer has no obligations towards the exchange though in practice this proves to be the hardest sanction of all due to residual rights of owners of securities; and *6)* fines against directors (supported by the threat of meaningful personal financial liability and criminal sanctions).

The suspension of the company's securities from trading on the exchange may have serious effects. For example, it could prompt creditors

to demand immediate repayment of the money owing to them with the result that the company is brought to insolvency. A suspension of trading would also remove the market facility from investors who may wish to sell, and deny investors the basis for valuing their securities, including securities providing collateral for the holder's bank facilities. Sanction 5 therefore needs to be used with great caution and only when there are clear indications that the listed company is endangering market integrity and investor trust. If the halt is to be effective, no possible alternative market should be permitted. Similar considerations arise on withdrawal of listing.

Securities or other laws that impose financial liability and other civil sanctions on listed companies and their directors (sanction 6) should support sanctions and penalties imposed by the exchange. This may not be a sufficient deterrent for companies and "insiders" (directors and controlling shareholders) who intentionally mislead or defraud investors. Criminal sanctions are therefore an important supplement to civil (financial) liability.

INTERMEDIARIES

Conditions of Access to the Market

BEST PRACTICE 22

Access by intermediaries to the market should be governed by adequate licensing and supervisory arrangements that are equitably and fairly applied.

The regulator should address the minimum entry standards for the various categories of intermediaries[92], capital and prudential requirements; ongoing supervision and discipline of entrants; and the consequences of default and financial failure[93]. The licensing of market intermediaries involves the setting of minimum standards for market participants. They need to be consistently and equitably applied and a license should be refused if they are not met. Where licensing is the responsibility of the exchange, it should be subject to appropriate oversight by the regulator. The licensing authority should also have the power to suspend or withdraw the licence whenever the entry conditions are not (any longer) fulfilled. The exchange can play an important role in raising the standards of professional competence in all market activities and by introducing qualifications through training and examinations.

The supervision of market intermediaries should be focused on the areas where their capital, client money and public confidence may be most put at risk[94]. The regulator should establish mechanisms to monitor compliance by market participants, identify violations and apply appropriate enforcement measures, including penalties or sanctions. The capital adequacy requirement and solvency of intermediaries should be properly monitored, and to that end should be the subject of periodic and event-driven reporting to the regulator or the exchange. Independent auditors should regularly report on the financial position of intermediaries.

Fit and Proper Tests

BEST PRACTICE 23

Intermediaries have to be assessed on the basis of “fitness and propriety” criteria prior to the issue of a licence.

Many jurisdictions set out detailed criteria relating to the “fitness and propriety” of an applicant before a person/firm may be licensed. These criteria are intended to protect the investor. They must be applied to the principals[95] that own, manage or control the affairs of each firm. Regulation should determine the exact content of these criteria as well as how the tests are being applied (e.g. via face to face interviews or written procedures). These tests will usually include information about the following key criteria for judging the qualification of a principal[96]: *1)* personal financial integrity and reliability, including possible checks on past bankruptcy or insolvency; *2)* information on any criminal record and previous civil cases (including disqualification as company director or bankruptcy); *3)* professional qualifications and membership of professional bodies; *4)* complete work history and relevant experience.

Business Conduct of Intermediaries

BEST PRACTICE 24

There should be market conduct rules for avoiding or minimising the potential for conflicts of interest. Actual conflicts of interest need to be disclosed and managed in such a way that customers are not at a disadvantage.

Generally, exchanges may set market conduct rules for their market participants (members or shareholders), while the rules governing the relationships between the intermediaries and their customers are set by the regulator or by an SRO different from the exchange. The regulator, stock exchange and other SROs should formulate rules that provide guidance to market participants on the circumstances in which conflicts of interests may arise and ensure that there is appropriate disclosure when problems do occur. They should also protect customers from being disadvantaged when conflicts arise.

An intermediary must disclose to its customers any circumstance in which it may be about to carry out business for the customer that gives rise to a conflict of interest between the customer's interests and those of the firm or other customers. Should such conflicts arise, priority should be given to customer's interests. The regulator should monitor the potential that may arise for conflicts of interest to occur and, if necessary, address them. The regulator must also ensure that the stock exchange has procedures in place to prevent access to private information about market participants leading to conflicts of interest (and/or misuse of non-public information)[97].

BEST PRACTICE 25

Market intermediaries should conduct themselves in accordance with widely accepted international standards of business conduct.

The hallmark of good conduct, in the market as well as in the quality of services provided by intermediaries to customers, is that customers' business has priority. Customers must have utmost confidence in the integrity of the market. Investor confidence is not only based on the national legal framework and the market regulatory infrastructure. The maintenance of widely accepted international standards of business conduct and adherence to the standards of proper internal procedures by intermediaries are also key determinants of market integrity and confidence[98]. The regulator and exchange should work together to maintain these standards.

The Working Group recommends compliance with the international standards of business conduct promulgated by IOSCO and FIBV[99]. International standards of business conduct of intermediaries include the following[100]:

Honesty, Fairness and Market Integrity

An intermediary should adhere to high standards of honesty and fairness in transactions and act with due care and diligence in the best interests of its customers and the integrity of the market. Market intermediaries should refrain from any action that would hinder or disrupt the fair and orderly functioning of the market. The stock exchange and regulator must take measures to preserve the integrity of the stock market's

price formation mechanism, for example by offering protection to the public against malpractice in the execution of customers' instructions and other manipulative practices.

Diligence

An intermediary must act with due skill, care and diligence in conducting its business activities. In effecting securities transactions this means the best execution of customers' orders. An intermediary must deal with or on behalf of a customer at the best price (including agreed upon and fully disclosed commissions and charges) reasonably obtainable at a given time, executed on a timely basis, and otherwise to his best advantage[101].

Where an intermediary has control or is otherwise responsible for customers' assets, it should take every step to protect and secure customers' funds and property for which it is responsible and at all times keep them segregated from the firm's own funds. An intermediary must have arrangements whereby none of its directors or other employees deals in securities with any of the intermediary's customers other than through other appropriately licensed entities and that employees report promptly to the firm in writing any transactions on their own account.

An intermediary's buy and sell recommendations to customers should be based on adequate and reliable information about the issuer and the nature of the financial instrument[102]. An intermediary should also permit the customer for whom it intends to provide a buy/sell recommendation (or to conduct investment research) to have a reasonable opportunity to react first. Customer orders must take priority over the intermediary's dealings on his own account in the relevant securities.

Capabilities

An intermediary should have and use effectively the staff, equipment, and knowledge resources necessary for the proper performance of its activities. Exchanges should give consideration to what qualifications they should impose for membership. As a minimum, market intermediaries and principals should meet the criteria relating to "fitness and propriety".

An intermediary must ensure that its employees are qualified, competent, and adequately trained to be able to comply with statutory and stock exchange rules relevant to its business activities. Specifically, market intermediaries should adhere to financial responsibility rules promulgated by the regulator and exchange. They should be able to calculate, monitor and report their financial position with sufficient frequency to the exchange and the regulator. An intermediary must maintain adequate financial resources to meet its business commitments and withstand the risks to which its business is subject. Likewise, intermediaries should have in place effective risk control systems.

Information about Customers

An intermediary should obtain from each customer information about their financial situation, investment experience and investment objectives ("know your client"), so as to make suitable recommendations. Likewise, an intermediary handling any type of public offer of securities must take care that its offering is adapted to the customer's investment needs and risk tolerance.

Every intermediary must maintain full, accurate and up-to-date records for each customer providing information about their resources, risk tolerance and financial standing, knowledge of securities and every transaction carried out by the firm, the customer's positions in securities, and copies of the exchange of letters, or other agreement, between the firm and each customer. The exchange may wish to specify the type of documentation for disclosing the information necessary to recommend suitable investments to customers, specifically where clients have a fiduciary role.

Information for Customers

An intermediary must make available certain information to customers and potential customers in writing, including:

- the number of the licence issued for its securities business on all written communications and advertisements issued by the firm;

- adequate disclosure of information (in a timely and comprehensible way) needed to make an informed investment decision[103].

- all relevant material information in dealing with its customers including whether customer money will or may be deposited in a bank which is an associate of the firm and, if so, the name of the bank; and details of the basis on which the firm supplies its services. Before transactions take place, a firm must also disclose the basis or amount of its charges for providing services.

- a contract of engagement with a customer[104] and a full and fair account of the related fulfilment of its obligations. To that end, a firm must provide timely and accurate reports to the customer about business undertaken for or with the customer. In cases where the firm executes a sale or purchase of a security for a customer, it is essential that on the day of the trade the firm sends its customer a contract note containing the essential details of the transaction, as specified in the stock exchange rules.

All advertisements for business or recommendations to buy or sell securities, including investment research material, distributed or published by a firm shall be truthful, fair, not misleading and clear to any reader, presented in a balanced manner, avoid incorrect comparisons and material omissions, and contain suitable risk warnings.

Record of Customer's Instructions

An intermediary must maintain a proper record of the instructions given by each customer so that they can be checked against individual transactions after they have been carried out. Details required by the stock exchange to be included in this record must be set out on a standard form and be made available. In cases where prior to taking instructions from a customer, a firm offers advice or recommendations as to the course of action that the customer should take, a record of that advice or recommendation should be made to facilitate the resolution of any dispute that subsequently arises between the customer and the firm.

Market Information should be Available on a Non-discriminatory Basis

Information about the market should be available on a non-discriminatory basis and cover market activity (information about what has taken place in the market must be readily available to all participants and the public, including information vendors) and commencement and termination of trading (all market participants must be informed which securities may be traded, or, when a trading halt is necessary, from what moment in time such actions take effect).

Prompt Execution of Instructions

Once instructions have been received from a customer the intermediary must execute them promptly, allocating the securities traded to the respective customer immediately.

Prompt Handling of Disputes and Complaints

Each complaint or dispute involving a customer and a market participant must be recorded and dealt with promptly in a practical manner.

Conflicts of Interest

Intermediaries should try to avoid conflicts of interest. If full transparency of prices and trading activity is maintained, potential conflicts of interest can be avoided or reduced[105]. When potential for conflicts does arise, a firm must ensure that in principle all customers are treated both fairly and in an equitable manner by proper disclosure, internal rules of confidentiality or declining to act[106] where a conflict cannot be avoided.

Compliance of Licensed Intermediary Firms with Laws, Regulations and Standards of Business Conduct

BEST PRACTICE 26

Intermediaries should have effective policies and procedures in place for complying with laws, statutory and self-regulatory obligations as well as with international standards of business conduct.

An intermediary should comply with any relevant laws, statutory regulations and self-regulatory obligations as well as with international standards or codes of business conduct. To that end, intermediary firms need to have in place effective internal policies and procedures for supervision and control. Hence, the compliance function entails both compliance with applicable external legal and regulatory requirements as well as with adherence to the standards following from or related to the firm's own internal policies and procedures.

This includes proper risk management by the intermediary. Regulation should require proper risk controls[107] but the firm has the responsibility to design and implement proper internal risk control procedures suitable for the firm's size and business. The exchange may assist the regulator in the periodic evaluation of these internal risk management processes. Likewise, the firm should develop and implement effective policies, operational procedures and controls in relation to other day-to-day business operations (dealing, exchange of information, safeguarding and managing the assets of customers, etc.), as well as meeting statutory and self-regulatory requirements and adhering to standards of business conduct. Their effectiveness should be monitored and evaluated by a separate, independent compliance function[108].

The directors and officers of the intermediary firm must accept full responsibility, collectively and individually, for compliance by the firm with the relevant laws, rules and regulations. Failure to do so should be grounds for the regulator and the exchange to take disciplinary proceedings against the member or any of its principals.

Compensation for Customers in Cases of Insolvency of Intermediary

BEST PRACTICE 27

Compensation for customers that lose money when the intermediary goes bankrupt should be made available from a compensation fund.

Compensation to customers due to the insolvency of an intermediary is usually covered either by a fund established by the industry through contributions levied on the activity of the market participants or possibly by a government fund. The fund must not be used for compen-

sating losses resulting from "regular" investment decisions by investors as part of normal market operations. Intermediaries should also carry insurance cover for a variety of risks that could arise in the course of their business, including untoward action by staff employed in those firms and disputes.

Sanctions and Penalties for Intermediaries

BEST PRACTICE 28

The regulator and the stock exchange should have at its disposal a variety of sanctions and penalties to be imposed on intermediaries to address improper conduct by market intermediaries. These sanctions and penalties should be used in a proportionate manner, and should be subject to review and appeal via a procedure of due process.

The range of sanctions and penalties should cover administrative, civil and criminal remedial measures. The regulator and exchange[109] should have an array of remedies to assure compliance with regulatory and self-regulatory requirements. Examples of sanctions imposed by the regulator or exchange[110] include: *1)* a warning; *2)* a reprimand in private or by way of public statement; *3)* a fine, as stipulated by law or in a contract with the exchange; *4)* a public statement of censure; *5)* the imposition of conditions on the operations of the firm, its principals or employees; *6)* the temporary suspension of the member firm or any of its executives from all market facilities for a defined period; *7)* the termination of membership of the stock exchange and dealer association; *8)* a recommendation by the stock exchange to the regulator that the licence of a member be suspended[111]; *9)* the transmission of the file to the judicial authorities for action under criminal law; *10)* the termination of the firm's license; *11)* acting as *amicus curiae* in private sector law suits against firms.

The regulator should require a stock exchange to meet appropriate standards before allowing it to exercise its self-regulatory, disciplinary authority. Regulatory oversight of the exchange should be ongoing[112]. The regulator should be able to sanction an exchange that fails to perform its regulatory duties adequately[113].

APPENDIX I: GLOSSARY

Book entry system	An accounting system that permits the electronic transfer of securities without the movement of certificates.
Central counterparty	An entity that interposes itself between the counterparties to trades, acting as the buyer to every seller and the seller to every buyer.
Central securities depository (CSD)	An institution for holding securities that enables securities transactions to be processed by means of book entries. Physical securities may be immobilised by the depository or securities may be dematerialised (so that they exist only as electronic records).
Certificate	A document that evidences the ownership of, and the undertakings of the issuer of, a security or financial instrument.
Clearance	The term “clearance” has two meanings in the securities markets. It may mean the process of calculating the mutual obligations of market participants, usually on a net basis, for the exchange of securities and money. It may also signify the process of transferring securities on the settlement date, and in this sense the term “clearing system” is sometimes used to refer to securities settlement systems.
Collateral	An asset or third-party commitment that is accepted by the collateral taker to secure an obligation of the collateral provider vis-à-vis the collateral taker.

Confirmation	The process in which the terms of a trade are verified either by market participants directly or by some central entity (typically the marketplace). When direct market participants execute trades on behalf of indirect market participants, trade confirmation often occurs on two separate tracks: verification (generally termed confirmation) of the terms of the trade between direct participants and verification (sometimes termed affirmation) of the intended terms between each direct participant and the indirect participant for whom the direct participant is acting.
Counterparty	A party to a trade.
Credit risk	The risk that a counterparty will not settle an obligation to its full value, either when due or at any time thereafter. Credit risk includes replacement cost risk and principal risk. It also includes the risk of settlement bank failure.
Cross-border settlement	A settlement that takes place in a country other than the country in which one trading counterparty or both are located.
Custodian	An entity, often a bank, that safekeeps securities for its customers and may provide various other services, including clearance and settlement, cash management, foreign exchange and securities lending.
Custody	The safekeeping and administration of securities and other financial instruments on behalf of others.
Custody risk	The risk of loss on securities in safekeeping (custody) as a result of the custodian's insolvency, negligence, misuse of assets, fraud, poor administration or inadequate record keeping.
Deferred net settlement system	A settlement system in which final settlement of transfer instructions occurs on a net basis at one or more discrete, prespecified times during the day of processing.

Delivery	Final transfer of a security or financial instrument.
Delivery versus payment	A link between securities transfers and funds transfers that ensures that delivery occurs if, and only if, payment occurs.
Dematerialisation	The elimination of physical certificates or documents of title that represent ownership of securities so that securities exist only as accounting records.
Exchange	An exchange is an entity that has direct administration over the market regardless of the way or form of market organisation and/or the financial products traded.
Final settlement	The discharge of an obligation by a transfer of funds and a transfer of securities that have become irrevocable and unconditional.
Gross settlement system	A transfer system in which the settlements of funds or securities transfer instructions occurs individually (on an instruction by instruction basis).
Immobilisation	Placement of physical certificates for securities and financial instruments in a central securities depository so that subsequent transfers can be made by book entry, that is, by debits from and credits to holders' accounts at the depository.
Issuer	The entity that is obligated on a security or financial instrument.
Legal risk	The risk that a party will suffer a loss because laws or regulations do not support the rules of the securities settlement system, the performance of related settlement arrangements, or the property rights and other interests held through the settlement system. Legal risk also arises if the application of laws and regulations is unclear.
Liquidity risk	The risk that a counterparty will not settle an obligation for full value when due, but on some unspecified date thereafter.

Local agent	A custodian that provides custody services for securities traded and settled in the country in which it is located to trade counterparties and settlement intermediaries located in other countries (non-residents).
Margin	Generally, the term for collateral used to secure an obligation, either realised or potential. In securities markets, the collateral deposited by a customer to secure a loan from a broker to purchase shares. In organisations with a central counterparty, the deposit of collateral to guarantee performance on an obligation or cover potential market movements on unsettled transactions is sometimes referred to as margin.
Market users	Market users include intermediaries, customers, vendors of and subscribers to market information.
Markets for securities	Markets for securities are arrangements with facilities and services relevant to equity and debt securities, options and derivative products. In addition to traditional organised exchanges, secondary markets should be understood to include various forms of *off-exchange* market systems. These systems include electronic "bulletin boards" and "proprietary" systems developed by intermediaries, typically offering their services to other brokers, banks and institutional investors who meet the operator's credit standards. The organised exchanges are the main focus of regulation. Regulation appropriate to a particular secondary market will depend upon the nature of the market and its participants.
Marking to market	The practice of revaluing securities and financial instruments using current market prices and requiring the counterparty with an as yet unrealised loss on the contract to transfer funds or securities equal to the value of the loss to the other counterparty.

Netting	An agreed offsetting of mutual obligations by trading partners or participants in a system, including the netting of trade obligations, for example through a central counterparty, and also agreements to settle securities or funds transfer instructions on a net basis.
Operational risk	The risk that deficiencies in information systems or internal controls, human errors or management failures will result in unexpected losses.
Principal risk	The risk that the seller of a security delivers a security but does not receive payment or that the buyer of a security makes payment but does not receive delivery. In such an event, the full principal value of the securities or funds transferred is at risk.
Real-time gross settlement	The continuous settlement of funds or securities transfers individually on an order-by-order basis as they are received.
Registration	The listing of ownership of securities in the records of the issuer. An official registrar/transfer agent often performs this task.
Repurchase agreement	A contract to sell and subsequently repurchase securities at a specified date and price.
Revocable transfer	A transfer that a system operator or a system participant can rescind.
Rolling settlement	A procedure in which settlement takes place a given number of business days after the date of the trade. This is in contrast to account period procedures in which the settlement of trades takes place only on a certain day, for example a certain day of the week or month, for all trades that occurred within the account period.
Same day funds	Money balances that the recipient has the right to transfer or withdraw from an account on the day of receipt.

Securities settlement systems	The full set of institutional arrangements for confirmation, clearance and settlement of securities trades and safekeeping of securities.
Segregation	A method of protecting client assets and positions by holding and designating them separately from those of the carrying firm or broker.
Settlement	The completion of a transaction through final transfer of securities and funds between the buyer and the seller.
Settlement bank	The entity that maintains cash accounts used to settle payment obligations associated with securities transactions. The settlement bank may be a commercial bank, the settlement system itself, or a central bank.
Settlement date	The date on which parties to a securities transaction agree that settlement is to take place. This intended settlement date is sometimes referred to as the contractual settlement date.
Settlement interval	The amount of time that elapses between the trade date (T) and the settlement date. The settlement interval is typically measured relative to the trade date; for example, if settlement is to occur on the third business day following the date of the trade, the settlement interval is referred to as T+3.
Settlement risk	A general term used to designate the risk that settlement in a transfer system will not take place as expected. This risk may comprise both credit and liquidity risk.
Straight-through processing	The completion of pre-settlement and settlement processes based on trade data that is manually entered only once into an automated system.

Subcustodian	A custodian that holds securities on behalf of another custodian. A global custodian, for example, may hold securities through another custodian in a local market. The latter custodian is known as a subcustodian.
S.W.I.F.T.	S.W.I.F.T, the Society for Worldwide Interbank Financial Telecommunications, provides a secure messaging service for interbank communication. Its services are extensively used in the foreign exchange, money and securities markets for confirmation and payment messages.
Systemic risk	The risk that the inability of one institution to meet its obligations when due will cause other institutions to be unable to meet their obligations when due. Such a failure may cause significant liquidity or credit problems and, as a result, might threaten the stability of or confidence in markets.

Sources: IOSCO. *Objectives and Principles of Regulation*. (September, 1998); COSRA. *Principles of Effective Market Oversight*. (May 1995); Consultation Report of the CPSS-IOSCO Joint Task Force on Securities Settlement Systems, *Recommendations for Securities Settlement Systems*, January 2001; FIBV, *Market Principles*, (1998).

APPENDIX II: LIST OF WORKING GROUP MEMBERS

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OECD	Mr. Hans BLOMMESTEIN Head of Emerging Financial Market Programme Enterprise Development Unit Directorate for Financial, Fiscal & Enterprise Affairs OECD 2 rue André Pascal 75775 Cedex 16 Paris FRANCE

NOTES

1. COSRA. *Principles of Effective Market Oversight.* (May 1995).

2. FIBV. *Market Principles.* (1999).

3. IOSCO. *International Conduct of Business Principles* (1990), IOSCO. *Objectives and Principles of Regulation.* (September 1998).

4. OECD. *Principles of Corporate Governance.* (1999).

5. G-30 (1989) *Clearance and Settlement Systems in the World's Securities Markets, Group of Thirty*; ISSA (2000), *Recommendations: 2000, International Securities Services Association*; FIBV (1996), *Clearing and Settlement Best Practices*, Federation Internationale des Bourses de Valeurs; CPSS, *Delivery Versus Payment in Securities Settlement Systems*, BIS, 1992.]; The Consultation Report of the CPSS-IOSCO Joint Task Force on Securities Settlement Systems, *Recommendations for Securities Settlement Systems*, January 2001.

6. A list of members of the Working Group is provided in Appendix 2.

7. See J. Greenwood and B. Jovanovic, (1990), "Financial Development, Growth, and the Distribution of Income", *Journal of Political Economy, 98 (5);* M. Obstfeld, (1994), "Risk-Taking, Global Diversification, and Growth", *American Economic Review, 84(5);* R. Atje and B. Jovanovic, (1993), "Stock Markets and Development", *European Economic Review, 37(2);* R. Levine and S. Zervos (1998), "Stock Markets, Banks, and Economic Growth", *American Economic Review, 88(3);* J.A. Minier, *Opening a Stock Exchange*, January 2001.

8. OECD, (1998), *Capital Market Development in Transition Economies, Proceedings*; H.J. Blommestein and M.G. Spencer, (1996), "Sound Finance and the Wealth of Nations", *North American Journal of Economics and Finance, volume 7*; B.S. Black, "The Legal and Institutional Preconditions for Strong Securities Markets", *UCLA Law Review* (48), forthcoming.

9. Andrea M. Corcoran, *Building Market Infrastructure, Futures Industry*, December 1995/ January 1996; IOSCO. *Objectives and Principles of Regulation.* (9/1998); B.S. Black, "The Legal and Institutional Preconditions for Strong Securities Markets", *UCLA Law Review* (48), forthcoming.

10. This information is in part based on submissions by Members of the Working Group and earlier work done at the OECD on the development of capital markets in transition countries and other emerging financial markets.

11. See OECD, (1998), *Capital Market Development in Transition Economies, Proceedings;* and Ruben Lee, (1998), "The Development of Capital Markets in Central Asia", *OECD Financial Market Trends, 71*, November.

12. See OECD, (1998), *Capital Market Development in Transition Economies, Proceedings*, in particular the chapter on the Czech experience.

13. B.S. Black, "The Legal and Institutional Preconditions for Strong Securities Markets", *UCLA Law Review* (48), forthcoming.

14. A complex tax code limits the development of financial markets. Stamp and withholding taxes and related registration fees can discourage new issuance and trading on the secondary market. Differences in tax treatment of residents and non-residents, institutions and individuals, treasury and corporate securities, and interest and capital gains can discourage market development.

15. Some analysts argue that they should be made to function at preferably the level of the regulatory authority of the stock exchange.

16. See Annex 3 in IOSCO. *Objectives and Principles of Regulation.* (September 1998).

17. The financial accounting framework is usually not considered part of the legal framework but is normally discussed in the context of disclosure by issuers.

18. IOSCO. *Objectives and Principles of Regulation.* (September 1998).

19. Andrea M. Corcoran, *Building Market Infrastructure, Futures Industry,* December 1995/ January 1996.

20. Specifically, regulatory requirements should provide that professional traders cannot front run or otherwise take advantage of customer orders.

21. Some countries mention as reason the need to establish one big and liquid domestic market.

22. COSRA. *Principles of Effective Market Oversight.* (May 1995).

23. COSRA. *Principles of Effective Market Oversight.* (May 1995).

24. IOSCO. *Objectives and Principles of Regulation.* (September 1998); COSRA. *Principles of Effective Market Oversight.* (May 1995).

25. See section 4 in IOSCO. *Objectives and Principles of Regulation*. (September, 1998); COSRA. *Principles of Effective Market Oversight*. (May 1995).

26. See B. Black and R. Kraakman, (1996), "A Self-Enforcing Model of Corporate Law", *Harvard Law Review* (1911) for an analysis of controls on self-dealing in transition countries. See also B.S. Black, "The Legal and Institutional Preconditions for Strong Securities Markets", *UCLA Law Review* (48), forthcoming, for details.

27. IOSCO. *Objectives and Principles of Regulation*. (September 1998).

28. See B.S. Black, "The Legal and Institutional Preconditions for Strong Securities Markets", *UCLA Law Review* (48), forthcoming, for a detailed and excellent discussion in the context of transition countries.

29. See R.J. Gilson and R. Kraakman, (1984), "The Mechanics of Market Efficiency", *Va. Law Review* (70).

30. This reputation is based on acquired license, expertise, and track record.

31. IOSCO. *Objectives and Principles of Regulation*. (September, 1998); COSRA. *Principles of Effective Market Oversight*. (May 1995).

32. Andrea M. Corcoran, *Building Market Infrastructure, Futures Industry*, December 1995/ January 1996.

33. B.S. Black, "The Legal and Institutional Preconditions for Strong Securities Markets", *UCLA Law Review* (48), forthcoming.

34. OECD. *Principles of Corporate Governance*. (1999).

35. See the Glossary for the definition of an "Exchange".

36. IOSCO, *Objectives and Principles of Securities Regulatio*n, September 1998.

37. IOSCO, *Objectives and Principles of Securities Regulation*, September 1998.

38. IOSCO, *Objectives and Principles of Securities Regulation*, September 1998.

39. IOSCO, *Objectives and Principles of Securities Regulation*, September 1998; Report of IOSCO *Emerging Markets Committee*, June 1996 (53), *Legal and Regulatory Framework for Exchange Traded Derivatives*; COSRA Report, *Principles of Effective Market Oversight*, May 1995; Report of FIBV International Capital Markets Group, *Standards of Self-Regulation of the Securities Markets*, 1992.

40. IOSCO defines securities settlement systems to include the full set of institutional arrangements for confirmation, clearance and settlement of securities trades and safekeeping of

securities. [Consultation Report of the CPSS-IOSCO Joint Task Force on Securities Settlement Systems, *Recommendations for Securities Settlement Systems*, January 2001.]

41. See Report of FIBV International Capital Markets Group, 1992, *Standards of Self-Regulation of the Securities Markets*. The 1998 IOSCO *Report on Objectives and Principles of Securities Regulation* notes that various models of self-regulation exist and the extent to which regulation is used varies.

42. See section 7 of the *IOSCO Report on Objectives and Principles of Securities Regulation*, September 1998.

43. See section 7 of the *IOSCO Report on Objectives and Principles of Securities Regulation*, September 1998.

44. See Report of FIBV International Capital Markets Group, 1992, *Standards of Self-Regulation of the Securities Markets*.

45. See section 7 of the *IOSCO Report on Objectives and Principles of Securities Regulation*, September 1998.

46. COSRA Report, *Principles of Effective Market Oversight*, May 1995.

47. See section 7 of the *IOSCO Report on Objectives and Principles of Securities Regulation*, September 1998.

48. Andrea M. Corcoran, *Building Market Infrastructure, Futures Industry*, December 1995/ January 1996.

49. COSRA Report, *Principles of Effective Market Oversight*, May 1995.

50. In some countries (e.g. in the UK), companies listed on the exchange must designate a principal or director to be a compliance officer responsible for ensuring that the company fulfils all legal, regulatory and other requirements of the marketplace.

51. Consultation Report of the CPSS-IOSCO Joint Task Force on Securities Settlement Systems, *Recommendations for Securities Settlement Systems*, January 2001.

52. Being either or both of the exchange operator and the regulator.

53. *IOSCO Report on Objectives and Principles of Securities Regulation*, September 1998.

54. However, the requirement to provide market information (price, quotes, volumes, etc.) to the general public does not imply that it has to be supplied for free. For many exchanges, the sale of trading data is a major source of revenues.

55. The conditions for this derogation need to be clearly defined [*IOSCO Report on Objectives and Principles of Securities Regulation*, September 1998].

56. Clearing involves the calculation of obligations of direct parties to the trade (see Glossary).

57. Settlement is the final transfer of securities (delivery) in exchange for final transfer of funds (payment) in order to discharge or terminate the obligation (see Glossary).

58. Registration is the listing of ownership of securities in the records of the issuer. An official registrar/transfer agent often performs this task. Many settlement systems have associated registries. They assist issuers in communicating with securities owners about dividends and other corporate decisions. [Consultation Report of the CPSS-IOSCO Joint Task Force on Securities Settlement Systems, *Recommendations for Securities Settlement Systems*, January 2001].

59. Usually all these services are not provided by the same entity.

60. The Consultation Report of the CPSS-IOSCO Joint Task Force on Securities Settlement Systems, *Recommendations for Securities Settlement Systems*, January 2001, recommends that "Securities settlement systems should have a well founded, clear and transparent legal basis in the relevant jurisdictions".

61. See Glossary.

62. Although they are more cumbersome, bearer certificates are still widely used in many jurisdictions.

63. Consultation Report of the CPSS-IOSCO Joint Task Force on Securities Settlement Systems, *Recommendations for Securities Settlement Systems*, January 2001.

64. Costs can be reduced through automation and economies of scale. Also the costs of cross-border trades can be reduced via links between CSDs in different jurisdictions.

65. If a CSD is also the registrar, it can eliminate any delay between settlement and registration.

66. The effective functioning of these markets is very much dependent on securities settlement systems that are low-cost, reliable and fast.

67. The Consultation Report of the CPSS-IOSCO Joint Task Force on Securities Settlement Systems, *Recommendations for Securities Settlement Systems*, January 2001, recommends that governance arrangements for CSDs should be designed to promote the interests of both owners and users, while satisfying the public interest. A CSD has many features of a public good.

68. G-30. *Clearance and Settlement Systems in the World's Securities Markets*. (1989).

69. The Consultation Report of the CPSS-IOSCO Joint Task Force on Securities Settlement Systems, *Recommendations for Securities Settlement Systems*, notes in its introduction that some of the G30 standards no longer represent best practice, while they ignore some important issues such as the legal base of settlement systems, transparency, access, governance, and regulation and oversight. Suggestions for updates have been made by FIBV [Clearing and Settlement Best Practices, 1996] and ISSA [Recommendations 2000] but the 1989 recommendations by G30 remain the only standards that have achieved global support and official endorsement.

70. Consultation Report of the CPSS-IOSCO Joint Task Force on Securities Settlement Systems, *Recommendations for Securities Settlement Systems*, January 2001.

71. For cross-border transactions international central securities depositories (ICSDs) have been created.

72. Custodians keep records of securities on behalf of investors.

73. Consultation Report of the CPSS-IOSCO Joint Task Force on Securities Settlement Systems, *Recommendations for Securities Settlement Systems*, January 2001: Technical Committee of IOSCO, Client Asset Protection, 1996.

74. Technical Committee of IOSCO, Client Asset Protection, 1996.

75. See Glossary.

76. Consultation Report of the CPSS-IOSCO Joint Task Force on Securities Settlement Systems, *Recommendations for Securities Settlement Systems*, January 2001.

77. In case of immobilisation physical documents are being deposited in the vault of the CSD.

78. See Glossary.

79. The Consultation Report of the CPSS-IOSCO Joint Task Force on Securities Settlement Systems, *Recommendations for Securities Settlement Systems*, January 2001, recommends that the benefits and costs of a central counterparty mechanism should be assessed. The Report also notes that the ability of a central counterparty to control rigorously the risks it assumes and to absorb losses is essential to the soundness of the market.

80. See Glossary.

81. See CPSS, *Delivery Versus Payment in Securities Settlement Systems*, BIS, 1992. The Consultation Report of the CPSS-IOSCO Joint Task Force on Securities Settlement Systems, *Recommendations for Securities Settlement Systems*, January 2001, recommends that settlement at the end of the day should be considered a minimum and that intra-day or real-time finality should be provided where necessary because of the need to control various risks.

82. See Glossary.

83. Securities lending arrangements have important benefits, including offering an efficient means of financing securities portfolios, by supporting participants' trading strategies and by reducing the risk of failed settlements [Technical Committee of IOSCO and CPSS, *Securities Lending Transactions: Market Development and Implications*, BIS, 1999]. The Consultation Report of the CPSS-IOSCO Joint Task Force on Securities Settlement Systems, *Recommendations for Securities Settlement Systems*, January 2001, makes recommendations for securities lending. In the context of emerging markets "merit-based" regulation can be important. [See the preamble to this document for additional information.]

84. See section 10 in *IOSCO Report on Objectives and Principles of Securities Regulation*, September 1998 for additional description of disclosure rules. Detailed information can be found in Reports of the IOSCO Technical Committee, *International Equity Offers*, September 1991 (16); *Report on Disclosure and Accounting*, October 1994 (39); Reports of IOSCO Development Committee, *Report on Disclosure Requirements*, October 1992 (24); *Report on Disclosure*, October 25, 1993 (32); Report of IOSCO Emerging Markets Committee, *Reporting of Material Events in Emerging Markets*, September 1996 (62); IOSCO Report, *International Disclosure Standards for Cross-Border Offerings and Initial Listings by Foreign Issuers*, September 1998.

85. FIBV 1998 *Market Principles*. See also OECD, *Principles of Corporate Governance*, 1999, for standards on disclosure and transparency from a corporate governance perspective.

86. This includes the responsibility of the regulator for ensuring: (a) the sufficiency and accuracy of information (this involves sanctions or liability on the issuing company and others responsible for the due diligence process) and (b) that proper responsibility is taken for the content of information (depending upon the circumstances this may include the issuing company and its authorising officers, underwriters, promoters). [See section 10 in *IOSCO Report on Objectives and Principles of Securities Regulation*, September 1998 for additional details.]

87. Initial listing criteria include the number of shares outstanding, the number of shareholders, the aggregate market value of publicly held shares, recent earnings and net tangible assets [Report of FIBV International Capital Markets Group, *Standards of Self-Regulation of the Securities Markets*, 1992]. Listing criteria apply to each prospectus or equivalent document supporting initial listing, the terms for entry to regulated trading for each class of security and relevant continuing obligations. Regulators and exchanges must lay down standards for offering prospectuses by issuers, including procedures for national offerings of securities, and the use of high quality national accounting and auditing standards that are internationally acceptable.

88. The exchange-related costs are just part of the total costs of issuing. Banker-related costs are usually the main part.

89. FIBV 1998 *Market Principles.*

90. That is, the actions to be taken if a rule or established practice is violated; how quickly violations will be investigated; remedies for violations; identification of the parties that commit violations need to be clearly identified from among market participants, intermediaries, or perhaps other investors; identification of the parties that suffered as a consequence of a violation of the rules; whether these rights are adequately specified in the law.

91. This point has been addressed by two US agencies in recent releases. Both the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC) argue that effective financial reporting is the result of high-quality accounting standards in conjunction with the faithful application of these standards by company management, effective audits of financial statements, and regulatory oversight and enforcement of the requirements. [FASB (1999), *International Accounting Standard Setting: A Vision for the Future*; SEC (2000), *Concept Release: International Accounting Standards*.]

92. Market intermediaries include professional market operators who are in the business of: executing orders; dealing in securities; portfolio and asset management; distributing and underwriting securities; and providing information relevant to the trading of and investment in securities.

93. *IOSCO Report on Objectives and Principles of Securities Regulation*, September 1998.

94. In part 12 of the *IOSCO Report on Objectives and Principles of Securities Regulation*, the following three risks are identified: *(a)* incompetence or poor risk management may lead to failure of due execution, due settlement or adequate advice; *(b)* breach of duty leading to misappropriation of client property, the misuse of client instructions for the benefit of the intermediary (e.g. "front running"), trading manipulations or outright fraud; *(c)* insolvency of intermediary resulting in loss of client funds, securities or trading opportunities.

95. FESCO (Forum of European Securities Commissions) expects the following categories of individuals to be fit and proper: directors, other senior management and individuals holding 10 % or more of the capital or voting rights in the firm or which makes it possible to exercise a significant influence over the management of the firm. [FESCO, *European Standards on Fitness and Propriety to Provide Investment Services*, April 1999, (99-FESCO-A)]

96. FESCO, *European Standards on Fitness and Propriety to Provide Investment Services*, April 1999 (99-FESCO-A); *IOSCO Report on Objectives and Principles of Securities Regulation*, September 1998; FESCO, *Standards for Regulated Markets Under the ISD*, December 1999 (99-FESCO-C).

97. See section 7 of the *IOSCO Report on Objectives and Principles of Securities Regulation*, September 1998.

98. *IOSCO Report on Objectives and Principles of Securities Regulation*, September 1998; and FESCO, *Standards for Regulated Markets Under the ISD*, December 1999 (99-FESCO-C).

99. IOSCO Resolution 16. See also Report of IOSCO Technical Committee (8), *International Conduct of Business Principles*, July 9, 1990; FIBV, *Market Principles*. (1999); *IOSCO Report on Objectives and Principles of Securities Regulation*, September 1998.

100. Although details of business conduct and the associated internal organisation of an intermediary will vary according to the size of the firm, the nature of its business and the overall business and risk profile of the firm and its affiliates, the general standards of business conduct reported here should be adhered to by any intermediary.

101. This also means that where off-market trading is permitted net trades or principal orders are executed at a price closely related to the market price. In this case the intermediary should also disclose the basis of the mark up or mark down to the customer.

102. For example, an underwriter should exercise due diligence with regard to an issuer's business conditions when preparing an offering.

103. Before recommending a transaction to a customer, the firm must take reasonable steps to give sufficient information and explanation to enable the customer to understand the nature of the risks involved. In respect of illiquid securities, this includes the possibility of having to deal with a very wide bid ask spread when the customer wishes to sell.

104. No trade should be executed without a written contract between the intermediary and the customer signed by both parties and setting the framework for business relations. In addition, each trade should be accompanied by written orders. An intermediary must obtain a customer's written consent only after explaining the risks involved to the customer, and before entering into a transaction under which a customer will or could incur further financial obligations or under which the customer will purchase a security which is not dealt in under the stock exchange's rules.

105. Proper internal organisational rules such as Chinese walls may also avoid or reduce potential conflicts.

106. Another possibility is that intermediaries manage actual conflicts by obtaining the informed consent of customers.

107. IOSCO Technical Committee Paper (78), *Risk Management and Control Guidance for Securities Firms and their Supervisors*, May 1998.

108. The compliance function should report directly to senior management and be independent from the operational departments. (*IOSCO Report on Objectives and Principles of Securities Regulation*, September 1998.)

109. The regulator or other government authority should have comprehensive investigation and enforcement powers including the power to impose administrative sanctions, to order to initiate matters for criminal prosecution, to order suspension or termination of licenses, etc. However, some of this power can be shared with SROs such as the exchange subject to supervision by and ongoing co-operation with the regulator. The regulator should take over the responsibility for an enquiry from an SRO where the powers of an SRO are inadequate for inquiring into or addressing particular misconduct or where a conflict of interest necessitates it. [*IOSCO Report on Objectives and Principles of Securities Regulation*, September 1998.]

110. The exchange should undertake those supervisory responsibilities for which it has incentives to perform most efficiently [*IOSCO Report on Objectives and Principles of Securities Regulation*, September 1998]. The exchange can use a range of sanctions and penalties, in addition to those available to the regulator. For example, the exchange should be able to suspend, expel, or fine members who violate relevant laws, regulations, and stock exchange rules [COSRA Report, *Principles of Effective Market Oversight*, May 1995].

111. The licensing authority should have the power to withdraw or suspend the license [*IOSCO Report on Objectives and Principles of Securities Regulation*, September 1998.]

112. *IOSCO Report on Objectives and Principles of Securities Regulation*, September 1998.

113. COSRA Report, *Principles of Effective Market Oversight*, May 1995.