



TC Podcast:

Securities Supervisors and Self-regulatory Organizations

Speaker:

Bert Chanetsa

Program Leader, Toronto Centre

Host:

Chuin Hwei Ng

Senior Program Director, Toronto Centre

Date:

May 15, 2025

Transcript:

Chuin Hwei Ng:

Hello and welcome to this Toronto Centre Podcast. I am Chuin Hwei Ng, Senior Program Director. Today, our topic is "Securities, Supervisors and Self-regulatory Organizations", or SROs. My guest today is a Toronto Centre program leader, Bert Chanetsa, who comes with a wealth of experience on this topic. Bert has served as Deputy Chief Executive Officer of the Financial Services World of South Africa, overseeing securities and capital markets regulation. He was also a board member of the International Organization of Securities Commissions (IOSCO) and Vice Chairman of IOSCO's Growth and Emerging Markets committee, where he contributed as a member of the monitoring board of the IFRS Foundation. Bert, a warm welcome to the podcast.

Bert Chanetsa:

Greetings, Chuin Hwei. Good to be here.

Chuin Hwei Ng:

Thank you. Bert, I'm wondering if we could start with definitions. What is an SRO and what are these entities in capital markets?

Bert Chanetsa:

The term SRO is one that is often bandied about. It's always good to make sure that we all have the same understanding of the term. An SRO, or self-regulatory organization, is an organizational entity which regulates and supervises the standards of practice and business conduct of its members. Generally, an SRO operates within a specific sector, industry, or profession. An SRO should not be mistaken for a government department. Rather, it coexists



with a statutory authority to which it is subordinate to varying degrees, depending on the jurisdiction in which it operates. SROs have been active in capital markets for a very long time. The best-known examples of SROs within the capital markets environment are stock exchanges, which I will be focusing on in this talk. Many of the best-known stock exchanges began as non-profit membership owned or mutualized entities. The owners of these entities were also the members who set their own rules, governing relationships amongst themselves and their members. The rules also covered business activities, including the operation of a securities trading platform. The SRO model has evolved, and most stock exchanges are now demutualized and operate with a distinct profit motive. Many are publicly listed companies. Other areas of capital markets in which one will encounter SROs include central securities, depositories, clearing houses, central counterparties, and payment systems.

Chuin Hwei Ng:

Why do we have SROs in the first place? What would be the typical scope of responsibilities?

Bert Chanetsa:

Many of the earlier SROs preceded regulation, hence the emergence of the membership model. As there was no regulation in place, they managed their own affairs in order to enable and establish efficacious business practices. For many years, they operated without regulation and without formalities. For a long time, traders in securities would consummate transactions with a verbal commitment to buy or sell a particular security at an agreed price. In the industry, "my word is my bond" was the motto. However, as markets and business practices have evolved and become more complex, regulation became necessary. Policy makers and legislators acknowledged the expertise residing within SROs, and rather than displace them, they kept them within the fold. The intention was for them to assist with the responsibility and burden of regulating and supervising participants and practices in the relevant industries.

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Predictably, statutory intervention has become more intrusive, particularly as a result of advances in technology, market systems have become much more integrated through market users, intermediaries, and payment systems. Differences between exchange and over the counter market structures have also had an impact. The scope of SRO responsibility varies tremendously. In some jurisdictions, SROs play a significant role in the regulation and supervision of the industries. In some cases, they have enjoyed so much autonomy that in practice, they only have reporting obligations to their statutory regulator. In other jurisdictions, the attitude of the policy makers and regulators is that capital markets are a public space, which requires statutory regulation and supervision. The arguments for statutory regulation and



supervision were strengthened by the move by previously mutualized entities to demutualized entities. They thus began operating with a profit motive. In these circumstances, the policy makers argued that the profit motive created conflicts of interest, which detracted from an SRO's ability to service the public fairly, especially where competition was involved. The result is that the division of responsibilities between statutory regulators and SROs is extremely varied.

One can encounter centralized government regulation on one hand and near autonomous self-regulation on the other, with many variations in between.

Chuin Hwei Ng:

What do the IOSCO principles and international standards have to say about SROs? Specifically, how should securities supervisors supervise them, and to what extent can securities supervisors rely on SROs?

Probably the most important (IOSCO) principle is Principle Nine, which recommends that SROs, which exercise direct oversight responsibility for their respective areas of competence, should be subject to oversight by the regulator and should observe the standards of fairness and confidentiality.

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Bert Chanetsa:

IOSCO's well-known view is that self-regulatory organizations can be a valuable component to the regulator in achieving the objectives of securities regulation. IOSCO has issued a number of principles which address the use of SROs in capital markets and securities regulation. Probably the most important principle is Principle Nine, which recommends that SROs, which exercise direct oversight responsibility for their respective areas of competence, should be subject to oversight by the regulator and should observe the standards of fairness and confidentiality. There are other principles which recommend the following: that trading systems should be subject to regulatory authorization and oversight, and that there should be ongoing regulatory supervision of exchanges and trading systems. This is to ensure that the integrity of trading is maintained through an appropriate balance between the demands of different market participants. The principles further recommend that there should be promotion of transparency of trading, and that there should be measures to detect and to deter manipulation and unfair trading practices.

IOSCO does not actually prescribe the manner in which SROs should be supervised. The main requirement is that where they are utilized, they should be subject to oversight by the statutory regulator. This gives the jurisdictions a lot of leeway, respecting the extent to which they utilize SROs. The important thing is that whichever way SROs are utilized, they should be supervised adequately.

Chuin Hwei Ng:

Could you take us through some of the common regulatory models you have seen on SROs?



Bert Chanetsa:

There are four basic types of SRO models of regulation, namely the government statutory model, the limited exchange model, the strong exchange model, and the independent member model.

In jurisdictions employing the government statutory model, the public authority has responsibility for securities regulation. This means that exchanges and other SROs are responsible for very limited supervision. This model is prevalent in the European Union countries as well as the UK.

In jurisdictions employing the limited SRO model, the public authority is still the primary regulator, but it relies on exchanges to perform certain frontline regulating functions. These functions should be tied to the operation of the market, including, for instance, market surveillance and listing. This model is utilized in Hong Kong, China, Singapore, and Sweden.

In jurisdictions employing the strong SRO model, the public authority is the primary regulator. However, it relies on exchanges to perform extensive regulatory functions which extend beyond their market operations, including regulating members' business conduct. Jurisdictions employing this model include Japan, through the Tokyo Stock Exchange and Osaka Stock Exchange. Also, Malaysia, through Bursa Malaysia, and South Africa, through the Johannesburg Stock Exchange.

In jurisdictions where the independent member SRO model has been adopted, the public authority is still the primary regulator. However, it relies extensively on an independent SRO, namely a member organization that is not a market operator. This SRO performs extensive regulatory functions. This model has been embraced in the USA through The Financial Industry Regulatory Authority or FINRA, also in Canada through The Investment Industry Regulatory Organization of Canada; in Japan, through the Japan Securities Dealers Association; in South Korea, through the Korea Financial Investment Association; and Columbia, through the AutoRegulator del Mercado de Valores de Columbia.

The primary objectives of securities capital markets regulation are investor protection, market integrity, and financial stability. Whichever model of supervision is adopted in a market, and this may incorporate the use of SROs, these main objectives must be observed.

Bert Chanetsa
Toronto Centre

Chuin Hwei Ng:

For security supervisors in emerging markets, what would you say are some of the key considerations for them in supervising SROs and in the SROs responsibilities?

Bert Chanetsa:

The primary objectives of securities capital markets regulation are investor protection, market integrity, and financial stability. Whichever model of supervision is adopted in a market, and this



may incorporate the use of SROs, these main objectives must be observed. Emerging countries need to be guided by the needs and requirements of their respective markets. Statutory regulators often lack the technical skills to take on exclusive or significant regulatory and supervisory responsibility for capital markets. On the other hand, whilst SROs can be expected to possess technical skills and knowledge derived from proximity to markets, they should remain accountable. In other words, statutory regulators should exercise visible oversight over them. SROs should never become a law unto themselves in reality or perception. Besides the skills differential, the issue of funding and resources also arises. This makes the collaborative approach inevitable. Policy makers in emerging markets need to consider whether self-regulation is appropriate for their markets. Issues for consideration include the jurisdiction's strategy for capital markets and priorities at key risks. In addition to investor protection, some jurisdictions have a development mandate. Whichever way the division of responsibility between a statutory regulator and an SRO goes, the regulatory approach must be flexible, effective, and efficient in order to provide the necessary protections in today's dynamic capital markets.

The regulatory framework should be continuously evaluated in the light of changes that are occurring and will occur. The regulatory framework should not lag behind or impede market innovations.

Chuin Hwei Ng:

Thank you once again, Bert, for sharing your insights and experience on this topic. You have been listening to a Toronto Centre podcast. Goodbye.