

Principles of Payments Industry Self-Governance

INTERNATIONAL COUNCIL OF PAYMENT ASSOCIATION CHIEF EXECUTIVES



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Executive summary

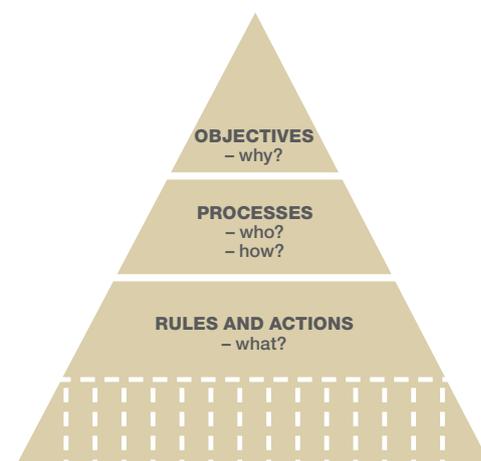
Industry self-governance – that is, the direction, development, administration and regulation of any industry with the involvement of industry participants – is an important feature of modern economies. Done well, it can correct market failures, deliver certainty, ensure equity amongst industry participants, promote efficient competition and innovation and deliver on other important policy goals.

This document focuses on the governance of payment systems by payments industry participants. Payment systems are critical to a well-functioning modern market economy. Despite a global history of extensive self-governance, payment systems are increasingly being asked to validate governance arrangements against key public policy requirements such as system stability, fair competition, system efficiency and innovation. Successful payment system self-governance now requires a co-regulatory partnership between industry and regulators.

The International Council of Payment Association Chief Executives (ICPACE)¹ has formulated these Principles of Payment Industry Self-Governance to provide some guidance as to how to maximise the efficiency and success of the co-regulatory partnership². It is intended that the Principles can be used as an assessment and comparative tool for improving payment system governance arrangements in many different payment systems. There are five Principles, outlined below and discussed in detail in Part 3.

Note that these Principles reflect the views of the Chief Executive Officers based on their own expertise and experience, and do not necessarily reflect the views of ICPACE member organisations.

The self-governance framework comprises three broad levels: its objectives, its processes, and its rules and actions. These are illustrated in the following diagram.



Objectives represent the purpose and policy goals of the governance framework. They must answer the question: why are we setting up this framework?

Processes represent the structural arrangements and understandings adopted by participants, including the role of each and the self governance procedures to be followed. They should articulate the powers, rights and obligations of each stakeholder. They must answer the questions: who will do what and how will they do it?

Rules and actions represent all the output of governance processes, made to enforce those instruments. They answer the question: what must we do to participate? Rules and actions can apply to the entire industry, illustrated by the upper layer, such as a rule book, code of conduct or technical standard, or to particular participants, illustrated by the lower layer, such as a licence, an approval or a ruling against a single party.

1. Members of ICPACE are APACS (UK), Australian Payments Clearing Association (Australia), Canadian Payments Association (Canada), European Payments Council (EPC), Irish Payment Services Organisation (IPSO), Payments Association of South Africa, (PASA) and Banking Association South Africa, Payments Strategy Division
2. ICPACE wishes to thank Gina Cass-Gottlieb and the Australian law firm Gilbert and Tobin for their invaluable work in preparing the initial report on which these principles are based.

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The five Principles that characterise a sound self-governance framework for payment systems are summarised below. In section 3, the Principles are explored further through consideration of implementation methods and issues.

1 Certainty

Principle: There must be absolute clarity of:

- objectives (policy goals) of the self-governance framework;
- the details and scope of any self-governance processes or structural arrangements adopted by the industry;
- powers and responsibilities of industry participants, any self regulatory organisations (SROs)³ and the government regulatory agency and the scope of their respective application; and
- rules and actions taken at an industry level.

Rationale: All stakeholders must share a common understanding of the self-governance framework, so they can participate in an informed and efficient manner that promotes industry stability and maintains investment incentives.

2 Legitimacy

Principle: The self-governance framework must be:

- agreed and adhered to by all relevant stakeholders, including all industry participants whose co-operation is necessary for the fulfilment of the framework's objectives;
- endorsed by government, through the facilitation of the regulatory authority;
- substantively and procedurally fair;
- backed by effective enforcement measures;
- accountable not only to the industry but to the government, whilst consulting with other external stakeholders; and
- able to sustain the above over time.

Rationale: Legitimacy is required if the self-governance framework is to be sufficiently stable and sustainable to command respect among its stakeholders and be effective in executing its governance functions.

3 Transparency

Principle: The objectives and processes must be publicly visible and accessible, as must the governance instruments and actions which emanate from those processes – subject to the commercial confidentiality required to maintain the integrity of the framework.

Rationale: Transparency is a cornerstone of good governance, and is needed to sustain both legitimacy and certainty, subject to genuine confidentiality requirements.

4 Flexibility

Principle: The governance framework must respond promptly to changes in the relevant markets as they evolve if it is to remain efficient and optimal over time.

Rationale: Best practice regulation should be proportionate to the market failure it addresses, hence it must be flexible as markets evolve. This in turn can facilitate dynamic efficiency in markets, including enabling efficient innovation to occur.

5 Efficiency

Principle: The governance framework should represent the least burdensome means of achieving the governance objectives by minimising cost and risk.

Rationale: Regulators, like markets, should be productively efficient. The process of regulation incurs substantial costs, and these should be minimised for the regulator and the industry (e.g. compliance costs), without compromising the objectives, while facilitating efficiency in relevant markets.

Paul Smee
APACS (UK)

Chris Hamilton
Australian Payments Clearing Association

Brad Gillis
Banking Association South Africa,
Payments Strategy Division

Guy Legault
Canadian Payments Association

Stewart McKinnon
European Payments Council

Pat McLoughlin
Irish Payments Services Organisation

Johnny Pienaar
Payments Association of South Africa

3. These Principles refer broadly to “self-governance”, so that a body formed by participants with industry governance or regulatory responsibilities might be termed a “self-governance organisation”. However, the term “self-regulatory organisation” or “SRO” is already commonly used to denote such bodies. To avoid confusion, we have retained the more common term.

Introduction

1 Purpose and scope

Payment systems are vital to the world's modern market economies. They are the financial vascular systems that link all parts of the economy. As such, they have grown rapidly in size and sophistication in the last decade or so.

It is hardly surprising then, that all over the world, payment systems are attracting increasing regulatory attention. Governments, particularly central banks, have a traditional policy interest in system stability and the avoidance of systemic risk. More recently, Government objectives have expanded to encompass competition policy and industry development issues such as fair access for new entrants, maximising economic efficiency for the benefit of users and the promotion of system innovation.

The focus of this document is payment system self-governance: The involvement of payment system participants in the direction, development, administration and regulation of the payment system. Historically, the world's market economies have been supported by payment systems with a heavy component of self-governance. As demonstrably successful as these arrangements have been, regulators are legitimately requiring that they be validated against public policy objectives. This requires a co-regulatory partnership between industry and regulators.

To provide some guidance as to how to maximise the efficiency and success of the co-regulatory partnership, the International Council of Payment Association Chief Executives (ICPACE) has formulated these Principles of Payment Industry Self-Governance.

The Principles are founded in a conviction that some degree of industry self-governance is crucial to long-term success: industry participants have both the highest levels of expertise, and the strongest natural incentives to ensure industry health and growth. Participants will also tend to both identify with and actively support broad industry objectives if they have responsibility for them. This must, however, be balanced with recognition that the legitimacy of payment system governance arrangements rests on a continuous demonstration that it meets public policy expectations. This is the essence of the co-regulatory partnership.

The Principles are designed to provide general guidance on the design of payments system governance arrangements to assist regulators, industry participants and system administrators, having relevance in many different jurisdictions and applications. Payment systems come in many different shapes. Some are administered by government bodies with industry input; some are mutual associations of competing organisations like banks and other financial institutions, and some systems are themselves commercial entities. In any particular payment system context, there are likely to be complex local considerations affecting the design of the governance framework. As such, the Principles are not a blueprint for any one "right" design, but rather suggest important issues to be considered in the design process. They can be used as a comparative and assessment tool for review and reform effort in each system.

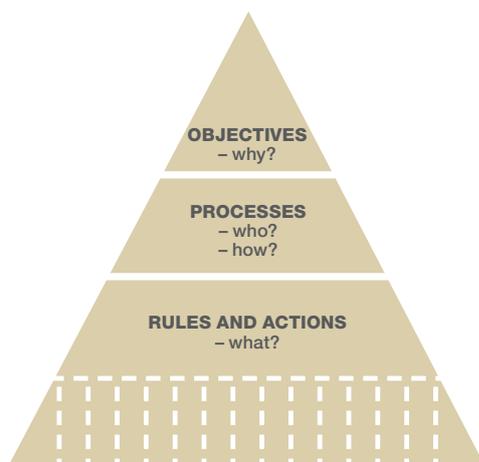
ICPACE is, as the name indicates, a grouping of payment association chief executives. The chief executives have agreed these Principles based on their own expertise and experience.

The principles have not been specifically approved by any payment association or group of association members. They should not be read as the concluded opinions or views of any one organisation, other than ICPACE.

Key Principles that underlie sound self-governance in the payments industry are identified in Part 3. Each Principle is then elaborated upon through discussion of the rationale, implementation mechanisms and implementation issues for each.

2 Governance frameworks

It is helpful to explain, at the outset, the main features of a payment industry governance framework. Broadly, we consider that any such framework exists at three levels, as follows:



Objectives represent the purpose and policy goals of the governance framework. They must answer the question: why are we setting up this framework?

Processes represent the structural arrangements and understandings adopted by participants, including the role of each and the self-governance procedures to be followed. They should articulate the powers, rights and obligations of each stakeholder. They must answer the questions: who will do what and how will they do it?

Rules and actions represent all the output of governance processes, made to enforce those instruments. They answer the question: what must we do to participate? Rules and actions can apply to the entire industry, illustrated by the upper layer, such as a rule book, code of conduct or technical standard, or to particular participants, illustrated by the lower layer, such as a licence, an approval or a ruling against a single party.

2.1 Objectives

The objectives of a governance framework represent the purpose and policy goals being pursued. They can include system stability goals, competition policy goals, industry or system development goals or social policy goals. They provide the *raison d'être* for the governance framework, i.e. "why are we doing this?".

2.2 Processes

Governance processes set out the structural arrangements and understandings amongst the framework's stakeholders. They define the roles of each party, the powers, rights and obligations that each bear, and the procedures they will follow in meeting the objectives. These may be manifested through legislation created in consultation with the industry, industry charters or agreements with government. In cases where detailed rules and requirements must be administered, industry institutions may be established to give effect to the governance framework. Such bodies are often called "self-regulatory organisations" (**SROs**)⁴.

These processes create the framework in which regulation is created, or governance decisions are made, by establishing who does what to whom, and how it must be done.

2.3 Rules and actions

Rules and actions are the output of the governance processes. They answer the question: what must we do to participate? "Rules" might include business rules, codes of conduct, operational standards and other protocols that govern how parties must act. Actions include a wide range of rulings, requirements, conventions or activities that are designed to make the framework operate effectively and smoothly. Examples include operational procedures, technical standards, dispute resolution requirements, enforcement rulings, compliance programs developed by industry participants, and monitoring and auditing programs to ensure industry compliance programs are being followed.

3 Organisation of this report

The remainder of this report is structured as follows:

- Part 2 examines issues relating to "good" governance generally, and in the context of payment systems. This part then considers some features and challenges in the self-governance of payment systems.
- Part 3 examines in detail five Principles that characterise a framework for successful self-governance of payments systems: certainty, legitimacy, transparency, flexibility and efficiency.
- Attachment A is a glossary of key terms.

4. These Principles refer broadly to "self-governance", so that a body formed by participants with industry governance or regulatory responsibilities might be termed a "self-governance organisation". However, the term "self-regulatory organisation" or "SRO" is already commonly used to denote such bodies. To avoid confusion, we have retained the more common term.

Good governance of payment systems

In this Part, we consider what makes good industry governance in a general sense. This initial discussion positions the subsequent discourse on self-governance and self-regulation within the broader context of good industry governance practices. We then go on to consider the particular characteristics of payment systems, and how these may refine the governance requirements.

1 What is good industry governance?

In a market economy, the primary motivation for participant behaviour is commercial and competitive in nature; industry governance should allow maximum economic freedom of action. Since all governance frameworks necessarily entail some curtailment of the economic freedom of industry participants, they must start from a compelling rationale based in policy objectives for the benefit of the broader community and/or the industry itself. Good governance is limited to the minimum restriction necessary to achieve these policy objectives. Good governance ensures that the benefits flowing from the framework – for participants and users – clearly outweigh the costs and the compliance burden imposed. It is sufficiently flexible to cope with changing institutional and product structures without losing effectiveness. Good industry governance should not get in the way of innovation.

Governance costs should be properly allocated, in that these costs are borne by those enjoying the benefits of regulation. Good industry governance may also seek to be competitively neutral, meaning that the governance burden applying to a particular commitment or promise should apply equally to all who make such commitments.

The Organisation for Economic Co-operation and Development's (OECD) *Guiding Principles for Regulatory Quality and Performance* outlines what good regulation should do, and provides a sound guide for good industry governance:

Good regulation should: (i) serve clearly identified policy goals, and be effective in achieving those goals; (ii) have a sound legal and empirical basis; (iii) produce benefits that justify costs, considering the distribution of effects across society and taking economic, environmental and social effects into account; (iv) minimise costs and market distortions; (v) promote innovation through market incentives and goal-based approaches; (vi) be clear, simple and practical for users; (vii) be consistent with other regulations and policies; and (viii) be compatible as far as possible with competition, trade and investment-facilitating principles at domestic and international levels.⁵

A 2007 report by the UK Centre for the Study of Financial Innovation has an even stronger focus on minimising regulation⁶. The report was developed in response to a perception of over-regulation in the UK financial services sector, and includes the following regulatory precepts:

- Formal regulation should be a last resort;
- The benefits should outweigh the disadvantages; and
- Regulation should be based on principles.

The principles of good industry governance can be implemented using different models. Governments, for example, typically use laws and other legislative instruments to regulate various spheres of social and economic life, and rely on the legal system and other state agencies to enforce those laws. While useful, excessive reliance on this type of “command and control” regulation by government can have significant implications for competition and economic performance, and may not be effective in meeting wider social objectives.

5. OECD's *Guiding Principles for Regulatory Quality and Performance*, (n.d.) at 3.

6. Principles in practice: an antidote to regulatory prescription, CSFI, 2007.

Given these risks, international organisations such as the OECD have sought to encourage governments to consider a range of regulatory options before deciding how to deal with a policy issue. For example, the third question on the 1995 OECD checklist for regulatory decision-making is to consider whether regulation is the best form of government action, recommending that:⁷

Regulators should carry out, early in the regulatory process, an informed comparison of a variety of regulatory and non-regulatory policy instruments, considering relevant issues such as costs, benefits, distributional effects and administrative requirements.

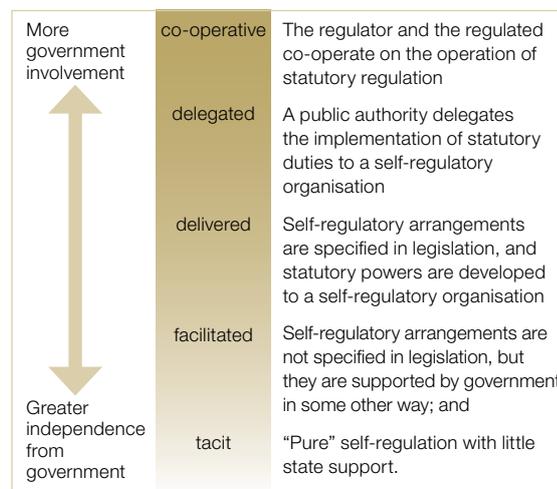
As a mechanism for meeting broad industry policy objectives, industry self-governance can have several major advantages over government regulation. The key advantage is the ability of a self-governance framework to draw on the extensive industry-specific knowledge and expertise of its members, allowing it to tailor system structure and regulatory design to meet the specific challenges faced by the industry and to be more flexible and responsive to changing circumstances:

Industry practitioners... have more expertise and technical knowledge than public officials and are more able to foster contacts within the industry and keep knowledge up-to-date. Practical rules are more easily developed which can lead to greater effectiveness and compliance.⁸

Closely linked to greater access to industry knowledge and expertise is the issue of efficiency and costs. Self-governance will have greater access to industry information provided by industry members, which will result in lower governance costs. Lower costs will also result from increased use of informal settlements over disputes under a self-regulatory model.⁹

In practice, self-governance and government-imposed regulation will almost always co-exist and support each other. For example, Bartle and Vass describe five varieties of self-regulation that represent various degrees of independence from government regulation, in the following diagram.

Spectrum of self-regulation



The options along this spectrum, save for the “pure self-regulation” approach, are all degrees of co-regulation in that the self-governance framework operates to a greater or lesser extent under the umbrella of government oversight and, in some cases, intervention.

Bartle and Vass’s five varieties of self-regulation are affected by the best practice principles that follow. Because the principles contribute to the level of industry and government comfort with the self-governance framework, a larger degree of comfort translates into greater scope for industry self-governance being afforded by the government. This moves the industry towards the more independent end of the self-regulation spectrum.

No particular level of self-governance will perfectly fit all circumstances. Rather, the optimal level of self-governance relative to government oversight will require a balance to be struck through consultation with industry, stakeholders and the government. Globally, payment industries in different jurisdictions can be placed at various points on the spectrum, both in terms of the type of governance model that is in place and the nature and extent of industry self-governance.

7. OECD, *Recommendation of the Council of the OECD on Improving the Quality of Government Regulation*, 9 March 1995, at 9.
 8. I Bartle & P Vass, *Research Report 17: “Self-regulation and the regulatory state – a survey of policy and practice”*, 2005 at 7.
 9. I Bartle & P Vass, *Research Report 17: “Self-regulation and the regulatory state – a survey of policy and practice”*, 2005 at 7.

2 The regulation of payment systems

In this sub-section, we consider some particular characteristics of payment systems and their implications for governance and regulation.

The Bank for International Settlements (**BIS**) Committee on Payment and Settlement Systems defines payment systems as “systems that comprise a set of instruments, banking procedures and, typically interbank funds transfer systems that ensure the circulation of money”.¹⁰

Payments systems are vital to the overall stability and efficiency of the financial system,¹¹ with nearly all economic transactions involving payment of some kind. The safe and efficient functioning of systems for effecting payment is therefore an issue of wide public concern. Not surprisingly then, the regulation of payment systems is an issue that occupies the attention of governments and international organisations such as the BIS.

It is generally accepted that the regulation of payment systems should seek to promote their safety and efficiency and to reduce systemic risk. Typically, but not always, this task is the responsibility of central banks. The BIS has referred to this role as the “oversight” of payment systems – defined according to the BIS as “[a central bank function] whereby the objectives of safety and efficiency are promoted by monitoring existing and planned systems, assessing them against these objectives and, where necessary, inducing change.”¹² The definition proposed by the BIS covers the public policy objectives of oversight (safety and efficiency), its scope (payment and settlement systems) and its main activities (monitoring, assessing and inducing change).

Beyond simple recognition of the need for oversight, regulation of payment systems is a complex matter. Payment systems are a network industry. Critical features of the operation of network industries, such as payment systems, can add challenge to designing an appropriate governance framework. Some of these features, demonstrated with examples from the payment systems industry, include:

- typically, many entities interact, including different types of service providers (e.g. card issuers and card transaction acquirers), infrastructure owners, end-users (e.g. those who make payments using the system and those who receive payment), the government regulator (e.g. the central bank), etc. Coordination between the activities of these different entities is often crucial to ensure the smooth operation of the industry;
- some entities may be competitors in respect of some of their activities (e.g. card issuers may compete with one another to attract end customers), while at the same time may need to cooperate with one another (e.g. for the purposes of ensuring the safe and efficient operation of the payments system);

- some network industries, including payment systems, operate as two-sided markets, with two distinct, interdependent groups of users. In the payment systems context, this requires balancing the interests of those who ultimately use the system to make payments (payers) with the interests of those who use the system to accept payments (payees), having regard to the interaction of network effects between those two groups;
- network industries, and particularly payment systems, often require high levels of infrastructure investment, for example to cater for new technological developments and new technologies to prevent fraud; and
- once a network technology, such as a particular payment system, becomes ubiquitous it may become entrenched, making it harder for other technologies to develop and prosper.

Given these features, there has been debate around the question of whether payment systems should be subject to their own form of Government regulation or whether they should be regulated using the same instruments applied to other industries (e.g. antitrust laws). Without seeking to resolve that debate, the authors note that these different views have resulted in different approaches to the regulation of payment systems in different jurisdictions. In Australia, for example, it has been deemed necessary to have separate arrangements for the regulation of payment systems, as shown in Case Study 1. However, this is by no means a universal approach, as shown in Case Study 2 by the UK experience.

Case Study 1 Australian co-regulation

The Payment Systems (Regulation) Act 1998 was introduced in Australia, where payment system governance had previously been almost entirely self-regulatory in nature, to allow for the “designation” by the Reserve Bank of areas of the payments system where it was deemed that government intervention was necessary ‘in the public interest’. Designation provided powers of imposing access regimes, the making of standards, arbitrating disputes and giving directions to act to participants in the payment system. The RBA is obliged, before taking any such action, to consult with the community. In an explanatory memorandum, the government expressly referred to this Act as implementing a co-regulatory framework under which designation would occur only where necessary to supplement self-governance.

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10. Bank for International Settlements Committee on Payment and Settlement Systems, *A glossary of terms used in payments and settlement systems*, 2003, at 38.

11. See for example, Wallis Committee, *Financial System Inquiry Final Report*, Australia, March 1997, at 363.

12. Bank for International Settlements, Report of the Working Group on Retail Payment Systems, *Policy issues for central banks in retail payments*, September 2002, at 50.

3 Self-governance in payment systems

As noted, payment systems have historically tended to develop within a self-governance framework. If, as suggested by the BIS, the governance oversight of payment systems combines a public policy dimension (i.e. maintaining safety and efficiency) with the need to monitor, assess and induce change, it is important to consider the feasibility of employing co-regulatory mechanisms to carry out all or some parts of that broad governance role. That is, we need to assess the division of governance responsibility between industry and Government.

Self-governance has significant advantages:

- the operation of payment systems typically requires a level of cooperation between industry members. Hence, they are likely to have common objectives and they may already have organisations in place to develop these common objectives;
- Payments infrastructure requires significant investment. The operators of a payment system are likely to have strong incentives to ensure that the payment system continues to operate well into the future (i.e. to protect their investment);
- the continued pace of change in payment technologies means competition between existing and emerging payment systems is likely, thus creating incentives to monitor performance of the system and inducing change (i.e. to stop the system from becoming obsolete); and
- given that the central bank, or other relevant government regulator, is likely to have a formal oversight role over payment systems, the desire to limit the scope of this intervention (or prevent it) could act as a strong incentive for successful self-regulation.

Case Study 2

Self-governance of UK payment schemes

In the United Kingdom, following the publication of the Cruickshank report in 2000, there were plans to introduce legislation which would give the Office of Fair Trading (OFT) specific powers over payment systems. These plans were, however, delayed when an OFT investigation in 2003 found that the owners of the UK payment schemes had implemented a number of self-regulatory reforms.¹³

In March 2006, the banks proposed a new Governance Model to the OFT's Payment Systems Task Force. This proposal eventually led to the establishment of the Payments Council in March 2007, which is now the body responsible for setting payment systems strategy in the UK. The body has objectives relating to efficiency within the payment system; the fostering of innovation; and the maintenance of integrity. It will shortly be consulting on a national plan for payments in the UK and is committed to working transparently and with consultation. Its Governing Body is chaired by a non-bank director and comprises eleven senior bank directors and four independents. The Payments Council has also entered into generic contracts with a number of payment schemes, including BACS Payment Schemes Ltd; the Cheque and Credit Clearing Co, LINK and CHAPS. These contracts set out the relationship between the schemes and the Council.

The operation of the Council will be reviewed by the OFT by March 2009.

The Payments Council has also entered into contracts (or other formal arrangements) with a number of payments schemes including the BACS Payments Schemes, CHAPS Clearing Company and Link ATM Scheme. These contracts set out the respective duties and rights of the schemes and the Payments Council.

The Payment Systems Task Force will continue to operate until at least 2008, at which time the government will assess whether further action is required in this sector.¹⁴

13. Office of Fair Trading (UK), UK Payment systems, May 2003, at 4.

14. Office of Fair Trading (UK), *Second annual progress report of the Payment Systems Task Force*, May 2006, at 35.

On the other hand, self-regulating payment systems create some challenges that must be managed by the framework:

- as noted by the BIS, the regulation of payment systems has a public policy dimension. Hence, a self-governance framework would need to decide whether it would internalise this public policy dimension (e.g. by including it as part of its own objectives) or whether it would find other means to deal with it;
- payments systems are increasingly international in nature. Because self-governance frameworks are typically domestic to one jurisdiction, they must consider how to manage participants not solely confined to that jurisdiction;
- any self-governance framework would need to develop a workable relationship with the relevant regulator, which is likely to retain oversight powers over the payment system despite the existence of a self-governance framework; and
- a self-governance framework would need to find mechanisms to address any potential (or perceived) conflict of interest issues that could arise if the industry participants that operate the payment system are also responsible for regulating it (including regulating the ability of new firms to become part of that system).

The last dot point raises the special role of competition (anti-trust) policy and law in successful industry self-governance and self-regulation. Every modern market economy imposes general restrictions on anti-competitive conduct, and some have specialised regulation to promote fair competition in the payments industry. The industry, through its leading participants and any association or SRO, needs to continuously demonstrate that self-governance arrangements impose no greater anti-competitive restrictions than are necessary to achieve the agreed industry and public policy objectives. This can lead to regular scrutiny of system access or membership arrangements and of any collective pricing principles or restrictions on market behaviour.

The best practice principles for the development of a successful self-governance framework for payment systems outlined in Part 3 have been developed with these challenges particularly in mind.

Case Study 3

South African National Payment System Advisory Body

The South African Reserve Bank (the SARB), in its role of overseer of the national payment system (NPS), identified the need to consult with, and act in collaboration with the various regulated stakeholders in the NPS.

Accordingly the National Payment System Department (NPSD) has established a payment system advisory board that will be representative of all the regulated stakeholders within the NPS. The National Payment System Advisory Board (NPSAB) will allow regulated bank and non-bank participants to establish associations which can represent the interest of their members at the NPSAB. The main focus of the NPSAB will be payment system related issues, specifically those issues that may have a risk-related impact on the NPS and participants in the NPS. Furthermore, the NPSAB will act in the interest of the system as a whole and not in the interest of individual participants.

The purpose of the NPSAB is to concern itself with, and to provide input on policy matters that affect the NPS. Furthermore, the purpose of the NPSAB is to provide a discussion forum to foster and facilitate collaboration between the various regulated stakeholders in the NPS. It should be clearly stated that it is not the intention of the NPSAB to be a market infrastructure, nor a payments association, nor a decision making body.

It is envisaged that the inaugural meeting of the NPSAB will take place early in 2008 and the constitution of the NPSAB will be the first point for discussion. The NPSAB will be chaired by the Executive General Manager responsible for the National Payment System and it is furthermore envisaged that the NPSAB will meet at least twice a year.

Recommended principles

This Part describes five Principles for Self-governance of Payment Systems. The discussion of each Principle contains an overview of the Principle's core elements and the rationale for its inclusion, as well as commentary on the practical application of each Principle.

1 Certainty

Principle 1: There must be absolute clarity of the:

- **objectives (policy goals) of the self-governance framework;**
- **the details and scope of any self-governance processes or structural arrangements adopted by the industry;**
- **powers and responsibilities of industry participants, any self-regulatory organisations (SROs) and the government regulatory agency, and the scope of their respective application; and**
- **rules and actions taken at an industry level.**

1.1 Overview and rationale

All stakeholders must share a common understanding of the self-governance framework. This will enable stakeholders to participate in an informed and efficient manner that promotes industry stability and maintains investment incentives.

To facilitate a common understanding, the objectives and processes of the self-governance framework must be precise and comprehensible to all stakeholders. Clarity of the objectives and processes will enable participants to know what their rights and responsibilities are. If there is an SRO in a particular industry, there should also be certainty about the nature of the SRO's powers and the way in which those powers may be exercised so that participants are able to make informed decisions.

One such set of principles that apply to bodies established by government to deal with national regulatory problems as well as government regulators, identify regulatory certainty as a principle of good regulation:

Regulation should have clearly identifiable outcomes and unless prescriptive requirements are unavoidable in order to ensure public safety in high-risk situations, performance-based requirements that specify outcomes rather than inputs or other prescriptive requirements should be used. This principle should also apply to any standards that might be referred to in regulation.¹⁵

While all investments are potentially risky, firms operating in regulated industries face "regulatory risk" which may dampen investment in new infrastructure projects or upgrades and extensions to infrastructure. This regulatory risk has two components:¹⁶

- regulatory uncertainty, which arises due to discretion afforded to regulatory authorities, the uncertainty in relation to the exercise of that discretion, and perceptions that regulatory decisions may be biased in favour of certain stakeholders; and
- regulated entities may be more exposed to the costs of market uncertainty than non-regulated entities because of the constraints that regulation imposes on their behaviour.

A self-governance framework that does not provide regulatory certainty is likely to be characterised by information asymmetries and hinder investment, both in payment systems infrastructure and in payment services using the infrastructure.

15. The Council of Australian Governments' (COAG) *Principles and Guidelines for National Standard Setting and Regulatory Action by Ministerial Councils and Standard-Setting Bodies*, amended June 2004, at 5.

16. Productivity Commission, *Review of the National Access Regime*, Inquiry Report No 17, 28 September 2001, at 68.

In a payment system context, any discretion afforded to SROs, and any uncertainty associated with the exercise of that discretion, may lead to perceptions that governance rules and actions may be biased in favour of certain participants and may also increase the level of risk associated with investment. This uncertainty could ultimately lead to systemic risk,¹⁷ as without governance certainty, participants are less likely to want to invest in developing new or maintaining existing infrastructure.

1.2 Certainty in practice

Certainty: Implementation mechanisms

- substantive stakeholder agreement
- clarity in founding documents (such as legislation, industry charter, any SRO constitution and rules of engagement)
- SRO or other industry representative should publish and adhere to clear guidelines outlining how it exercises the options open to it
- appropriate resourcing of the SRO, including the right skills mix (e.g. legal, technical and public affairs) to deliver consistency and predictability
- suitable engagement with government and its regulatory agency
- regular transparent reviews of objects
- clarity in who will bear the monitoring and review costs, although in most cases this will likely be the members

In practice, achieving certainty in a self-governance framework will require the precise definition of the framework's objectives, of participant's rights and obligations, and of all rules made and actions performed by any SRO. Ultimately, such certainty inspires confidence that decisions will be made consistently and predictably. Therefore, it helps if there is a process by which decisions can be informed by previous decisions that have gained acceptance as good or appropriate decisions.

Certainty in decision-making will also require definition in the procedural aspects of decision-making, e.g. defining relevant time limits, where appropriate, and clearly identifying circumstances where substantive contributions can be made to the decision-making process. For example, participants should be clearly informed about the circumstances in which consultation will occur and whether consultation is limited in respect of certain decisions. Importantly, if decisions are subject to discretionary powers, the scope of that discretion and any underlying policy objectives to be met should be clearly specified. This latter aspect is also a fundamental part of the Transparency Principle.

Indeed, many of the implementation options that are relevant to transparency are also relevant to certainty, particularly options relating to the disclosure of framework objectives, rules and procedures. There is also a strong correlation with the Efficiency Principle, as certainty in compliance mechanisms can allay concerns that regulatory outcomes would be unpredictable and risky for investment.

However, there are also a number of issues that arise when implementing the Certainty Principle. A significant issue is that there is a trade-off between achieving certainty and ensuring that the governance framework is sufficiently flexible to adapt to members' needs. This will be of particular importance to a self-governance framework as one of the key benefits of self-regulation over government regulation is the greater level of flexibility inherent in a self-governance framework. Another critical balance to be struck with the Certainty Principle is the need to achieve the right balance of independent self-regulation and government co-regulation, so that certainty can be delivered.

Ensuring that certainty in the governance framework translates into investment certainty is vital, as this will enable participants to reasonably anticipate how regulation will be applied. This requires adherence to the regulatory "contract"¹⁸ by the government regulatory agency, especially in view of sunk costs borne by the participants to the self-governance framework.

2 Legitimacy

Principle 2: The self-governance framework must be:

- **agreed and adhered to by all relevant stakeholders, including all industry participants whose co-operation is necessary to the fulfilment of the framework's objectives;**
- **endorsed by government, through the facilitation of the regulatory authority;**
- **substantively and procedurally fair;**
- **backed by effective enforcement measures;**
- **accountable not only to the industry but to the government, whilst consulting with other external stakeholders; and**
- **able to sustain the above over time.**

2.1 Overview and rationale

Legitimacy is required if the self-governance framework is to be sufficiently stable and sustainable to command respect among its stakeholders and be effective in executing its governance functions.

Legitimacy is a term used to refer to "a sense that an organisation is lawful, admissible, and justified in its chosen course of action".¹⁹ Legitimacy can be drawn from a wide range of sources: membership and representation of that membership, legal and industry recognition, relevant knowledge and experience. It can also be drawn from authentic and appropriate decision-making.

17. Bank for International Settlements, *Core Principles for Systematically Important Payment Systems*, January 2001, at 21-22.

18. The regulatory contract refers to the mutual understanding that all parties have at the outset of a governance framework regarding their reciprocal burdens and benefits, particularly regarding investment and rules of engagement. The understanding need not be legally enforceable but must be transparent.

19. M Edwards, *NGO Rights and Responsibilities: A New Deal for Global Governance*, Foreign Policy Centre, London, 2000.

In the context of industry self-governance, membership can be a source of legitimacy where the self-governance framework is able to demonstrate that it is representative of industry participants but sufficiently independent to make unbiased decisions. Unbiased representation is important, as the legitimacy of a self-governance framework may be called into question if the rules and procedures of the framework favour certain participants or special interest groups lobbying for particular outcomes. Diverse industry interests should be appropriately accounted for in designing the self-governance framework's membership rules. An SRO that is responsible for regulating payment systems, for example, should allow representation from all organisations that engage in the relevant payments activity, regardless of organisations type or class. Limited representation is likely to affect the ability of an SRO to "speak for the industry" and to advocate for or against proposals that would affect the legal and regulatory framework applying to the industry.

A self-governance framework can be said to have legitimacy if there is recognition of its powers and decisions by those it aims to regulate. This recognition increases the effectiveness of self-regulation as participants will comply with their obligations under the framework. Without legitimacy, there could be little industry buy-in to the framework, and correspondingly little success. As the Australian Securities and Investment Commission (ASIC) has noted, without legitimacy, self-regulation will flounder and may even be detrimental:²⁰

The old-style model for self-regulation of "set and forget" is not viable going forward. If accountability is not in place, then the risk is not just that self-regulation will be ineffective, but that it may be harmful as industry and regulators devote resources elsewhere on the assumption that self-regulation is working. If this occurs, the existence of self-regulation would be counter-productive.

In addition to recognition from the framework's members, there should also be legal recognition of the framework, as this will have an impact on the enforceability of the framework rules and decisions.

Legitimacy may be threatened if there is a perception that an SRO is acting purely in the private interest, which may be interests of the industry or of only certain participants, at the expense of the public interest. In the case of payment systems, the public interest can be considered to be the safe and efficient functioning of payment systems as an integral part of the financial system and the economy.

Another challenge to legitimacy relates to membership of any SRO. Membership must be broad, representative and accurately reflect industry interests. This entails ensuring that the majority of participants in regulated activity are members of the SRO. While voluntary participation is a feature of many self-governance frameworks, the question of whether purely voluntary arrangements will be effective needs to be considered carefully. In some circumstances, there will be sufficient incentives available so that all relevant industry members will join the self-governance framework on a voluntary basis. This is likely to be the case if, for example, there are significant reputational advantages for those that join, if joining is essential for the effective participation in the operation of the payment system, or if there are other reasons that mean the overall advantages of joining are greater than any disadvantages and costs.

There may be some tension between taking into account the public interest and providing appropriate representation of members. The European Commission's (EC) has observed that self-regulation "is a tool of the private sector. Much of self-regulation has nothing to do with public policy".²¹

Successful self-governance answers this concern by specifically considering industry regulation within the broader public policy context. Indeed, it is in the long term interests of members to consider public interest objectives, as failure to do so may impact upon the reputation, health and growth of the industry, and on the legitimacy, and ultimately the success, of self-governance itself. A self-governance framework which does not pursue the public interest and involves only limited participation from outside stakeholders may not be considered by government authorities to be an effective alternative to government regulation.

In many cases, the public interest and the industry's interests will align. For example, it could be said that public interest objectives such as effectiveness and efficiency are likely to be allied to the interests of the private players in the payment systems industry, with the failure of payment systems likely to have an impact on the investments and turnover of industry participants as well as to economic growth. Effective enforcement options are often a key aspect of maintaining legitimacy amongst the broader stakeholder community.

A balance of positive and negative incentives for industry participants may maximise the likelihood of efficient compliance, and thereby the success of self-governance arrangements. Where the balance between tough sanctions and gentle persuasion lies for each industry will depend on many factors, such as:

- the industry in question;
- industry incentives to participate;
- the particular powers afforded to any SRO; and
- the interactions between the regulated and the regulator.

20. ASIC, *Institutional self-regulation: what should be the role of the regulator?* Address by J Segal to the National Institute for Governance Twilight Seminar, Canberra, 8 November 2001.

21. European Commission, *Report of the Working Group 'Better Regulation'*, May 2001, at 7.

2.2 Legitimacy in practice

Legitimacy: Implementation mechanisms

- clear endorsement and authorisation from government
- membership eligibility criteria that cover all relevant industry stakeholders
- incentives for all relevant stakeholders to participate
- independent and unbiased decision-making and allowing appeals of decisions and rulings
- effective compliance and enforcement arrangements
- consistency with legal frameworks, e.g. competition law and procedural fairness

Many good approaches can assist the establishment or enhancement of legitimacy in a self-governance framework. The range of approaches stems from the number of sources through which legitimacy can be drawn. The discussion that follows outlines some implementation options in relation to two main sources of legitimacy: membership, and legal and industry recognition.

(a) Membership

As the BIS have suggested in their Core Principles:²²

It is important that those served by the system should be able to influence its overall objectives and performance. This can be achieved by various means depending on ownership. Representation on the governing body is one such means. Some structured forum for wider consultation can also be useful.

Governance arrangements for all systemically important payment systems should include a mechanism for ensuring objective and independent oversight/control over management. Such arrangements should ensure that management has the proper incentives to act in the interests of stakeholders and should include appropriate checks and balances for decision-making such as a system of internal controls, risk management, and audit reviews.

In other words, membership of a self-governance framework should be representative of industry that it purports to represent but also maintain some independence from the industry. This can be achieved by ensuring that:

- all relevant industry participants be allowed to participate as part of the self-governance framework (i.e. the framework should have appropriate and transparent membership requirements);
- there are sufficient incentives for industry participants to participate in the self-governance framework so that the framework is actually representative; and
- there is unbiased representation of the interests of the participants in the framework, such that decision-making is not “captured” by sectoral interests or infrastructure owners.

If a self-governance framework derives part of its power from a government regulator (either directly or by implication), that regulator may be considered to be a stakeholder. If there is government involvement, the right balance of government involvement must be struck. There should not be total disengagement, but neither should there be micro-supervision.

When implementing this principle, it will be important to maintain the right stakeholder mix in a changing industry. This also reflects and supports the need for the Flexibility Principle.

Legitimacy: Unbiased representation and membership

For legitimacy to be achieved through membership, unbiased representation of participants and stakeholders in the self-governance framework is required. In remaining unbiased, it may be necessary for an SRO to establish some independence from the industry.

This could be done by establishing a governing body that has a mix of representatives from key industry players, as well as independent members that have payment systems or other relevant expertise.²³ Another option is to require all members who serve on a governing body to act independently as individuals and not as representatives of particular organisations.²⁴

Other ways in which the independence of the SRO may be enhanced are by:

- providing a stable source of funding for the SRO;²⁵ and
- establishing independent performance reporting against a set of industry benchmarks.

(b) Legal and industry recognition

Legal and industry recognition is necessary if the self-governance framework’s rules and actions are to be legitimate and therefore enforceable. Legal recognition can be achieved through:

- formal recognition of the self-governance framework by the government, either where the framework is established following a delegation of power by a statutory regulator or where the framework evolves from the industry level;
- ensuring objectives, rules and decisions are consistent with the existing legal and regulatory framework; and
- enshrining the establishment of the self-governance framework in primary or delegated legislation.

Industry recognition can be achieved by implementing the membership options canvassed above.

22. Bank for International Settlements, *Core Principles for Systematically Important Payment Systems*, January 2001, at 7.10.8 – 7.10.9.

23. National Consumer Council (UK), *Better business practice – how to make self-regulation work for consumers and business*, January 2001, at 10.

24. Wallis Committee, *Financial System Inquiry Final Report*, March 1997, at 537.

25. Wallis Committee, *Financial System Inquiry Final Report*, March 1997, at 197.

Case Study 4
Legal recognition of the Canadian Payments Association

In Canada, the government has delegated the implementation of statutory duties in respect of payments' clearing and settlement to the Canadian Payments Association (CPA). The CPA was created in 1980 by an Act of Parliament, the *Canadian Payments Act*, which sets out the Association's legal framework, including its mandate, the types of organizations that are eligible for membership, the role of the Board of Directors and oversight responsibilities for the Minister of Finance. Under the Act, CPA by-laws are considered government regulations and are subject to approval by the Minister of Finance. In addition, the Minister has the authority to review new CPA rules or amendments to existing rules.

To enable a comprehensive review of the objects of the payments framework, the Canadian government undertakes a review of the financial legislative framework generally every five years, including the Canadian Payments Act, to ensure that the framework remains effective and its objects continue to be justifiable over time.

Implementation issues for achieving legal and industry recognition include:

- ensuring that all participants adopt a mindset of responsibility for regulatory outcomes (in contrast with the adversarial approach that regulated entities sometimes take to a government regulator), and
- ensuring that the processes employed for decision-making require an appropriate level of consensus without granting wide-ranging vetoes that would paralyse the process.

Because industry participants have a choice whether to abide by any industry rules or codes of conduct, there is a risk that the enforcement framework will be more lenient compared with what the public might choose or what might be imposed by the government.²⁶ To attain legitimacy, self-regulation must ensure that the SRO is not, by default, subject to "regulatory capture", and deal with any perceptions that it will be a reluctant intervener or a lenient enforcer.²⁷

The SRO will of course be required to justify any decisions made to its stakeholders, and potentially to the government regulator. This latter point is particularly important, due to the fact that self-regulation does not operate in a vacuum but, rather, operates in the context of the wider legal and regulatory framework. Some studies have shown that the self-enforcement of regulations may trend towards the level of the potential government regulation simply because the threat of government intervention is there (see following table).

Legitimacy: Enforcement levels in self-regulatory frameworks

DeMarzo et al, in a study on member owned and operated self-regulatory organisations in the United States securities markets, found that government oversight leads self-regulatory organisations to choose an enforcement policy which is "just aggressive enough to pre-empt the government from doing its own enforcement."²⁸ If the self-regulator imposes a penalty too far below that which would be imposed by the government, such that it is unacceptable to the public or the government, the government may decide to intervene with a stricter regulatory regime in order to protect the public interest.

The authors found that government oversight combined with the mere threat of government enforcement can lead to more aggressive enforcement by a self-regulatory organisation, even without any actual action on the part of the government.

3 Transparency

Principle 3: The objectives and processes must be publicly visible and accessible, as must the rules and actions which emanate from those processes – subject to the commercial confidentiality required to maintain the integrity of the framework.

3.1 Overview and rationale

A self-governing industry needs to demonstrate to participants, stakeholders and the regulator that it can be trusted with that responsibility.²⁹ One way of showing that it can be trusted, and thereby justify the absence of government intervention, is by making sure that the self-governance framework is as transparent as possible.

Transparency is an overarching concept and a guiding principle that applies to all levels of the governance framework. It is a cornerstone of good governance needed to sustain legitimacy, certainty and other key principles, subject to genuine confidentiality requirements. As an example, when recommending that the UK Financial Services Authority (FSA) should aim to make the regulatory process more transparent, the Cruickshank report concluded that:

26. PM DeMarzo, MJ Fishman, KM Hagerty, (2001) Kellogg School of Management Working Paper, *Contracting and Enforcement with a Self-Regulatory Organization*.

27. Of course, this does not mean that it must always intervene in a precipitous or heavy-handed fashion. Rather, it may demonstrate, in accordance with the transparency principle, that its reaction is proportionate and appropriate.

28. PM DeMarzo, MJ Fishman, KM Hagerty, (2001) Kellogg School of Management Working Paper, *Contracting and Enforcement with a Self-Regulatory Organization* at 32.

29. I Bartle and P Vass, Research Report 17: "Self-Regulation and the Regulatory State – A survey of policy and practice", 2005, at 5.

Transparency is a cornerstone of effective regulation. Putting into the public domain accurate and timely information about the actions of regulators, in this case the Financial Services Authority (FSA), and of regulated firms, reduces information imbalances, lets everybody know where they stand and can reduce the need for intrusive regulation of firms' behaviour.³⁰

Similarly, when formulating its recommendations, the Wallis Report in Australia had regard to the principle of transparency, noting that it should be a top priority of a regulatory structure.³¹ The Australian Government Taskforce on Industry Self-regulation also concluded in its 2000 report that self-regulatory frameworks should be transparent and open to scrutiny to improve market outcomes for consumers.³²

One of the transparency principles identified by the IMF is that where SROs are authorised to perform part of the regulatory and supervisory process, they should be guided by the same transparency practices specified for statutory regulators.³³ The IMF has defined transparency as:

an environment in which the objectives of policy, its legal, institutional, and economic framework, policy decisions and their rationale, data and information related to monetary and financial policies, and the terms of agencies' accountability, are provided to the public in a comprehensible, accessible, and timely manner.³⁴

In other words, the governance framework, and the processes that form a part of that framework, should be open, easy to understand and unambiguous. Further, transparency of regulation requires that all guarantees be made explicit.³⁵

Transparency can have a marked impact on the authority of an SRO, as well as the behaviour of its participants. As Gunningham and Rees observe:

Building transparency into the social structure of the industry sets the stage for a 'theatre of external judgment'... and as transparency increases so does the likelihood of being called to account for one's industrial conduct.³⁶

In the context of payments system self-regulation, transparency is critical, as it reinforces governance arrangements and facilitates consistency of decision-making.³⁷ Transparency about the role of the SRO, and how it interacts with the regulator, will assist in promoting public confidence in the payment system more generally, "by reassuring the public that there are no gaps in the regulatory framework."³⁸ This increases the chances that the regulator will have fewer reasons to intervene in the industry.

While numerous benefits are associated with transparency, the stability and effectiveness of the payments system must also be considered. For example, it may be appropriate to limit the implementation of the transparency principle where the public disclosure of certain decisions or information may jeopardise the stability and effectiveness of payment systems policies. The release of a central bank's contingency plans or security risk analysis, for instance, may undermine the effectiveness of policies relating to payment systems failure and security.

3.2 Transparency in practice

Transparency: Implementation mechanisms

- easily accessible founding documents setting out objectives and processes (e.g. constitution, decision-making framework and rules of engagement)
- easily accessible rules and actions (including industry codes, discussion papers, decisions and sanctions)
- proper resourcing of SRO if applicable (e.g. website, public affairs function, appropriately skilled staff)
- timely and open engagement with stakeholders
- appropriate review processes
- publication of review timetables and consultation processes
- multiple avenues for stakeholder involvement

Before examining more fully how transparency operates in practice, an issue to bear in mind is the *depth* to which transparency should reach in the self-governance framework.

Generally, transparency will need to extend to regulatory processes and actions, but not to transactions and confidential data. Transparency depth may be different for different classes of persons. It must enable access seekers, for example, to determine the technical standards and interface specifications with which they must comply, while excluding confidential information of other parties. The government or its regulatory agency may require deeper disclosure of material that is commercially confidential. Claims for confidentiality should be balanced against the need for an open and credible process.

30. D Cruickshank, *Competition in UK Banking – A Report to the Chancellor of the Exchequer*, March 2000, at xi.

31. Wallis Committee, *Financial System Inquiry Final Report*, March 1997, at 196.

32. Taskforce on Industry Self-regulation, *Industry Self-Regulation in Consumer Markets*, August 2000, at 71.

33. International Monetary Fund, *Code of Good Practices on Transparency in Monetary and Financial Policies*, September 1999, principle 5.5.

34. International Monetary Fund, *Supporting Document to the Code of Good Practices on Transparency in Monetary and Financial Policies*, Part 1, July 2000, at 47.

35. Wallis Committee, *Financial System Inquiry Final Report*, March 1997, at 196.

36. N Gunningham and J Rees, 'Industry Self-Regulation: An Institutional Perspective' (1997) 19(4) *Law & Policy* 363 at 386.

37. International Monetary Fund, *Code of Good Practices on Transparency in Monetary and Financial Policies*, September 1999, at 5.

38. International Monetary Fund, *Supporting Document to the Code of Good Practices on Transparency in Monetary and Financial Policies*, Part 3, July 2000, at 18.

Participants, such as banks, will also need to strike the right balance with the confidentiality of internal communications. For example, it may be commercially sensitive and inappropriate to disclose internal communications about a bank's operations. The disclosure of such information is likely to diminish the credibility of the process and also make participants reluctant to provide information and be actively involved in discussions. If an SRO is unwilling or unable to protect the commercial-in-confidence communications of participants, its effectiveness will be diminished.

(a) Transparency of objectives

The objectives of the self-governance framework should be clearly defined and effectively communicated to participants and stakeholders. Explanation should also be given for the need for self-regulation, how the self-governance framework is being used to meet legal and regulatory requirements applying to payment systems, and the broader policy objective of maintaining the effectiveness and stability of payment systems.

The objectives of most government regulators are usually specified in legislation or regulation. Methods a self-governance framework can use for explaining its objectives include websites, annual reports, press releases, communiqués and speeches.

Case Study 5 Transparency of activities of the Irish Payment Services Organisation Ltd.

Transparency of IPSO activities continue to be built upon with IPSO implementing all of the recommendations of the Competition Authority arising from its study of competition in the banking sector. These included:

- a) the finalisation of governance changes confirming the IPSO Board as the single, unified and inclusive decision-making body for the payments industry;
- b) the publication on the IPSO website of IPSO Board decisions;
- c) the publication of all constitutional documents, scheme rules and rules for participation in the clearings;
- d) the publication of a policy statement concerning the status of Credit Unions and An Post, vis-à-vis, membership of payment schemes;
- e) development of a Business Account Switching Code
- f) undertaking a cost benefit analysis of cheque truncation in Ireland

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(b) Transparency of processes and decisions made

The BIS identified as one of the Core Principles for Systematically Important Payment Systems the need for effective, accountable and transparent governance arrangements.³⁹ For the purposes of these principles, "governance arrangements" needs to be broadly defined to include how the payment system's objectives are set, how they are achieved and monitored.⁴⁰ It also includes the administrative processes – encompassing structural rules and policies, relationships, processes and systems – within which the owners of payment systems, its participants, its governing body and the regulator act and interact.

What constitutes transparent administrative processes will differ from industry to industry and depends largely on what is appropriate given the existing legal and regulatory framework, the nature of industry participants, the importance of the industry to the economy, and a range of other factors. The BIS considers that the following actions are likely to foster an environment in which transparency can be achieved:

- relevant, up-to-date and readily available information on the payment system and its operation;
- consultation with all relevant users and due deliberation before major decisions are made;
- high-level decision-making is prompt and communicated clearly;
- the payments system consistently attains projected financial results and can explain any differences from those plans; and
- the system delivers payment services which satisfy the needs of participants and their customers.⁴¹

The above is not intended to be an exhaustive list.

Depending on the legal and regulatory context in which the self-governance framework is operating, it may also be appropriate to include in the rules and procedures of the framework the key features of the payment system's settlement and risk management, as well as clear procedures for crisis management and dealing with payment systems failure.⁴²

39 Bank for International Settlements, *Core Principles for Systematically Important Payment Systems*, January 2001, at 53-56.

40 Bank for International Settlements, *Core Principles for Systematically Important Payment Systems*, January 2001, at 9; APCA and ABA, *Comparative Governance of Payment Systems*, 2006, at 2.

41 Bank for International Settlements, *Core Principles for Systematically Important Payment Systems*, January 2001, at 56.

42. US Federal Reserve, *Federal Reserve Policy on Payments System Risk*, updated 11 January 2007, at 8.

Finally, it should be acknowledged that payment systems may have some natural monopoly and network characteristics which means those payment systems, and their owners and operators, could have a degree of market power.⁴³ Administrative processes should therefore incorporate “checks and balances” so that the interests of the owners and operators of those systems do not eclipse the interests of non-owners and other stakeholders. At the same time, there should be checks and balances in place to ensure consistency in decision-making.

A formal consultation process with stakeholders should be implemented to ensure that strategies and objectives reflect stakeholder views, providing comfort that their views are considered and that policy is not set behind close doors. This is also an important element of the Principle of Legitimacy.

4 Flexibility

Principle 4: The governance framework must respond promptly to changes in the relevant markets as they evolve if it is to remain efficient and optimal over time.

4.1 Overview and rationale

Self-governance frameworks are confronted with the problem of how to remain relevant over time, particularly in an environment where factors, such as market structures, members' positions, customer technology used, customer preferences and competitive practices, are subject to change. Best practice regulation should be proportionate to the market failure it addresses, and hence must be flexible as markets evolve. This in turn can facilitate dynamic efficiency in markets, including enabling efficient investment and innovation to occur.

Although somewhat counter-intuitive, SROs will only achieve the stability required of them by their members if they are flexible enough to adapt to changes, both in the external and the internal self-regulatory environment.⁴⁴ The balance of whether there is too much or too little flexibility, though, is fragile – self-regulation that is not flexible enough will stifle innovation and investment, while too much flexibility will cause investor and industry uncertainty, which may also result in underinvestment in payment systems.

The ability to provide for sufficiently flexible self-governance arrangements is one of the defining advantages of self-regulation over government imposed regulation, and is therefore one of the key justifications for electing a self-governance model. Frank Donnan argues that the rule-making process is more flexible in the hands of SROs:

*SROs are able to modify their rules more quickly in response to developments in the business environment. The bureaucratic structures of government agencies and rigid, formal requirements for rule making and enforcement inhibit innovation and quick responses to sudden changes in the environment.*⁴⁵

It is important to emphasise that this flexibility must work in the long and medium term, rather than one-off or short term situations only. A long term approach to change will enhance industry confidence, not only because it ensures that changes to the governance framework will not be made arbitrarily, but also because the self-governance arrangement will be responsive to change when a genuine need arises.

Flexibility is important to all self-governance frameworks, but especially to the self-regulation of payment systems. The BIS lists a number of innovations in the payment systems industry which have all required flexibility in regulatory and self-regulatory approaches, including new options in internet payment facilities, electronic bill presentment and payment, payment portal services, e-money, and the use of mobile phones for the provision of payment services (amongst others).⁴⁶

The increasing need for more flexible self-regulatory approaches to meet the demands of a complex global economy undergoing rapid technological advance was recognised by two self-regulatory bodies in the United States securities market, NASD and the New York Stock Exchange. This resulted in a consolidation of the member regulation and enforcement arms of the two SROs in July 2007 (Case Study 6).

4.2 Flexibility in practice

Flexibility: Implementation mechanisms

- ensure that decision-makers anticipate market developments (risks and opportunities) so that regulation can be appropriately forward looking
- keep decision-makers well-informed by harnessing the industry to ask the right questions and collect relevant data
- ensure governance enables dynamic efficiency in regulated markets, e.g. by maintaining technology neutrality and enabling investment and innovation risks to be rewarded
- provide for agreed mechanisms for reviewing objectives and rules of engagement if either industry decision-makers or the government believe it is warranted

Given that flexibility is one of the major benefits of self-governance, governance arrangements should, at a minimum, allow for some flexibility to deal with changing circumstances and relationships within the payment systems industry, as well as other general economic developments. A balance, however, needs to be struck between this flexibility and the uncertainty that may be caused by constant changes to the

43. RBNZ (Financial Stability Department), *Payment system governance*, June 2007, at 1.

44. C Hahn et al (2007), 'Social Reputation: A Mechanism for Flexible Self-Regulation of Multiagent Systems', *Journal of Artificial Societies and Social Simulation* 10(1)2, at 3.5.

45. F Donnan, 'Self-regulation and the Demutualisation of the Australian Stock Exchange' (1999) 10 *Australian Journal of Corporate Law* 1 at 22.

46. Bank for International Settlements, Report of the Working Group on Retail Payment Systems, *Policy issues for central banks in retail payments*, September 2002 at Annex A.

self-governance framework. That is, the objectives of the flexibility principle must be weighed against the objectives served by the certainty principle on a case-by-case basis. Generally, flexibility is likely to be exercised most often at the lower levels of a governance framework: rules might be more easily able to adapt to the times; less so governance processes; and only rarely would objectives be altered.

Achieving the right balance between competing interests in determining when and how flexibility should be exercised is another implementation issue.

In order to reap the full benefits that flexibility can provide, the self-governance framework needs to have sufficient power to implement change, including to its own processes. Implementing change will require that the constitution and processes of the self-governance framework contemplate that change might occur. These rules and processes should specify matters such as what changes may be allowed, what consultation (if any) may be required before the change is implemented, what voting mechanisms will be put in place to approve (or oppose) the change, whose ultimate responsibility it will be to decide if changes will be implemented and to implement changes that have been approved, etc. It is also important to implement appropriate mechanisms that ensure there is regular consultation with participants and the relevant regulator. Consultation processes will enhance uptake of current thinking on industry-specific issues and trends from those most experienced in the industry, and could lead to efficiency gains from information sharing with the government regulator.

It is also recommended that the self-governance framework has in place internal processes to collect market information and information from participants. This information can be used to assess compliance with the framework's objectives and whether change may be needed to address any gaps.

Further tools to enhance flexibility consist of:

- including in the rules and regulations formal review processes of the organisation of the self-governance framework (e.g. every five years); and
- including in the rules and regulations mechanisms that give the self-governance framework a degree of discretion in the exercise of its functions and the enforcement of the framework's rules and regulations.

Case Study 6

Flexibility in New York securities self-regulation

In November 2006, NASD and the member regulation, enforcement and arbitration functions of the New York Stock Exchange (NYSE) formally announced a plan to consolidate into a new, independent self-regulatory organisation. The Financial Industry Regulatory Authority (FINRA) was created in July 2007, and is the largest non-governmental regulator for all securities firms doing business in the United States.

NASD and NYSE recognised that flexibility in their traditional approaches was necessary to modernise and ensure future regulatory effectiveness. "The creation of FINRA is the most significant modernization of the self-regulatory regime in decades," said Mary L. Schapiro, Chief Executive Officer of FINRA. "With investor protection and market integrity as our overarching objectives, FINRA will be an investor-focused and more streamlined regulator that is better suited to the complexity and competitiveness of today's global capital markets."⁴⁷

Consolidation was also needed in order to change the existing system of overlapping jurisdiction and duplicative regulation. The new organisation will have one uniform rulebook, which will afford the regulatory structure the flexibility necessary to more successfully accommodate different business models and firm size. FINRA will also have a new governance structure, blending existing NASD and NYSE rules and traditions, and one enforcement staff.

A major outcome of the flexibility which resulted in the new self-regulatory structure will be reduced costs for the industry and enhanced competitiveness of the US capital markets.

47. Financial Industry Regulatory Authority website, www.finra.org.

Any flexibility in enforcement must, however, be tempered with the need to have stability and certainty in self-governance arrangements. The Australian Law Reform Commission's (ALRC) report on Federal Civil & Administrative Penalties in Australia describes the balance between flexibility and consistency in a government regulatory setting in the following terms:⁴⁸

[R]egulators favour having a wide range of regulatory tools at their disposal to give them the flexibility to respond most appropriately to a given situation. This flexibility needs to be balanced with what has been described as a principle of good regulation, which is an attempt to standardise the exercise of discretion so as to reduce inconsistencies between government regulators, reduce uncertainty and lower compliance costs.

The ALRC further observes that exactly where this balance lies will affect the precision with which the governance rules are stated. Where an enforcement strategy is aimed towards prosecutions it will require more specific legislative objectives. Frameworks targeted at achieving compliance with good practice, on the other hand, will benefit from greater flexibility in their rules.⁴⁹

The precision with which the regulatory goals are set out by legislation can influence the regulatory approach. Generally, the more complex and precise the rules, the less scope there is for the exercise of discretion by the regulator. Most regulatory statutes give regulators broad discretions. This may be because legislators leave the statement of detailed objectives in specialist areas to those with relevant expertise. Legislators may deliberately avoid setting down precise objectives because they want regulators to have the freedom to cope with problems as they arise in the future. Different enforcement strategies call for different kinds of rules. If prosecutions are the main mode of enforcement, precise rules are called for. If the promotion of good practice is the objective, less precise but more flexible rules may be more effective.

Although the comments by the ALRC are directed at government imposed regulation, the general principles nevertheless apply to self-governance – namely, that self-regulatory bodies should be given a wide range of tools to secure compliance with their frameworks depending on the objective they are trying to achieve, and that those tools should be used in different ways in order to meet each different objective and to give due consideration to special circumstances.

Case Study 7 Canadian Payments Association providing mechanisms to anticipate market developments

The Canadian Payments Act provides objects for the Canadian Payments Association (CPA), including facilitating the interaction of the CPA's clearing and settlement systems and related arrangements with other systems or arrangements involved in the exchange, clearing and settlement of payments; and facilitating the development of new payment methods and technologies.

In pursuing its objects, specialized CPA Working Groups and Committees are established to examine specific issues in order to develop a thorough understanding of the issues and identify the impact that they might have on the Canadian payments system, and on the CPA.

These groups leverage the knowledge of their member and stakeholder representatives to identify evolving payment issues and risks in the context of the CPA's legislated objects and the changing marketplace, and make recommendations to the CPA's Board of Directors in respect of the CPA's role and responsibility. Through such mechanisms, the CPA can appropriately anticipate and react to market developments (both risk and opportunities), and aim to develop rules and standards that are suitably forward-looking so as to enable investment and innovation while maintaining technology neutrality.

48. ALRC, *Securing Compliance: Civil and Administrative Penalties in Australian Federal Regulation*, Discussion Paper 65, 2002, at [4.34].

49. ALRC, *Securing Compliance: Civil and Administrative Penalties in Australian Federal Regulation*, Discussion Paper 65, 2002, at [4.12].

5 Efficiency

Principle 5: The governance framework should represent the least burdensome means of achieving the policy objectives by minimising cost and risk.

5.1 Overview and rationale

Governance frameworks, like markets, should be productively efficient. Because regulation imposes substantial costs for the regulator and for the industry (e.g. compliance costs, costs of intervention, costs of regulatory risk and uncertainty), these costs should be minimised without compromising the policy objectives.

Government-imposed regulation may not always be the most efficient form of dealing with problems related to an industry or market. Self-regulation can often be more efficient than government regulation, as the participants in a self-governance framework will often have a more thorough knowledge and better understanding of the regulated industry than a government regulator.⁵⁰ A self-governance framework can also allow for less formal and more flexible mechanisms in terms of decision-making and compliance,⁵¹ all of which contributes to efficiency.

The principle of efficiency has two aspects to it, discussed below:

- minimising the impact of regulation by implementing only the minimum necessary to achieve policy objectives;⁵² and
- avoiding duplication between the rules and obligations of a self-governance framework and the existing legal or regulatory frameworks.

(a) Minimising the impact of regulation

As stated in the COAG Principles:⁵³

Working from an initial presumption against new or increased regulation, the overall goal is the effective enforcement of stated objectives. Regulatory measures and instruments should be the minimum required to achieve the pre-determined and desirable outcomes.

Minimising the impact of regulation means reducing the costs of self-regulation for those required to comply with the self-governance framework's rules and decisions. The costs of self-regulation vary but will generally involve administration, compliance and monitoring costs.⁵⁴

Regulatory costs are not a trivial matter. A report commissioned for the United States Small Business Association indicates that annual cost of US federal government regulations was an estimated \$1.1 trillion in 2004, and this is borne disproportionately by small firms.⁵⁵ Excessive administrative and compliance costs will discourage investment in the industry and may prevent new entry into the industry.

The Australian Taskforce on Industry Self-regulation notes that it will be the consumer who will ultimately bear the costs of regulation, as regulated firms will pass on regulatory costs:⁵⁶

[S]elf-regulation does come at a cost to both the industry and consumer. The costs involved in administering an inefficient self-regulatory scheme may be translated into higher prices for consumers resulting in a poor market outcome for both business and consumers. Compliance costs can also be high for business, which in turn, can be passed onto consumers. However, the Taskforce is not touting that schemes should be cost-effective at the risk of sacrificing consumer rights for example. It is necessary to ensure that the scheme is the effective minimum solution for the specific problem in hand.

It should be noted, however, that the lowest cost form of self-regulation will not always produce the most efficient outcomes. The issue of costs must therefore come second. Rather, it is necessary to first determine the objectives and desired outcomes before deciding on the most cost-efficient method of achieving those objectives and outcomes.

(b) Avoiding duplication with existing legal and regulatory framework

In establishing a self-governance framework, it is necessary to consider the existing legal and regulatory environment in which the new self-governance framework will operate. In the case of inconsistency between the legislative framework and the rules of a self-governance framework, the legislative framework will take precedence. Self-governance frameworks should therefore be designed to prevent such conflicts from arising. The need for payment systems to have, and be consistent with, a well-founded legal basis is one of the principles that the BIS has identified. As noted in its *Core Principles for Systemically Important Payment Systems*, such consistency is critical to the overall soundness of the system.⁵⁷

50. F Donnan, 'Self-regulation and the Demutualisation of the Australian Stock Exchange' (1999) 10 *Australian Journal of Corporate Law* 1 at 22.

51. Taskforce on Industry Self-regulation, *Industry Self-Regulation in Consumer Markets*, August 2000, at pages 56-7.

52. COAG Principles, at 5.

53. COAG Principles, at 5.

54. Taskforce on Industry Self-regulation, *Industry Self-Regulation in Consumer Markets*, Australia, August 2000, at 82-83.

55. WM Crain, (Sept. 2005) *Impact of Regulatory Costs on Small Firms*, online at <http://www.sba.gov/advo/research/rs264tot.pdf>. Note that the costs of self-regulation were not estimated in that report.

56. Taskforce on Industry Self-regulation, *Industry Self-Regulation in Consumer Markets*, August 2000, at 80-81.

57. Bank for International Settlements, *Core Principles for Systematically Important Payment Systems*, January 200 at 16.

Static legislative frameworks may not always be best placed to deal with dynamic change faced by the industry. As such, self-governing industries need to be given the latitude to lobby for change to be made to existing legislative frameworks where such frameworks no longer adequately enable the self-governance framework to efficiently meet the underlying objectives of industry regulation.

5.2 Efficiency in practice

Efficiency: Implementation mechanisms

- impose governance obligations only where the objective could not be reasonably achieved without regulation, and where the benefits exceed the costs
- ensure that decision-makers are kept well-informed in the least cost manner, by harnessing the capabilities of industry participants
- avoid duplication (or resolve conflicts) with other legal or regulatory frameworks
- ensure consultation with government at appropriate stages
- utilise regulatory tools, such as cost-effectiveness assessments, regulatory impact statements

Implementing the best practice principle of efficiency in self-regulation will require balancing the need for well-informed analysis against the need for timely decisions. This will involve determining what evidence or inquiry is necessary prior to decisions, and what procedural safeguards should apply before decisions are made. Another issue to be determined by the participants in a self-governance framework is the extent of appeal rights available from regulatory decisions. Such rights are important for procedural fairness, but if these rights are too extensive, sacrifices in efficiency will inevitably follow. A similar issue arises in respect of consultation processes – an excessively broad and inclusive consultation process will bog down the efficiency of the self-governance framework. Implementation issues such as these will need to be carefully thought through when establishing a self-governance framework in order to achieve the correct balance between the efficiency principle and other best practice principles, such as legitimacy and transparency.

In minimising the impact of self-regulation and avoiding duplication with the existing legal and regulatory framework, a self-governance framework should consider implementing some of the processes such as:

- a cost-effectiveness assessment;
- regulatory impact statements;
- regular regulatory monitoring and review;
- building investment incentives into the self-governance framework; and
- consideration of existing legal and regulatory framework.

These five processes are discussed below.

(a) Cost-effectiveness assessment

The efficiency of each self-governance administrative action should be assessed before that action is implemented to determine whether it is cost-effective. As COAG has concisely summarised, such an appraisal “compares the costs of different initial project options with the same or similar outputs and can be used where it is difficult to place a dollar value on the major benefits of a proposal”.⁵⁸

A cost-effectiveness assessment will assist a self-regulatory organisation in determining whether the proposed framework is the most efficient solution to the meet the pre-determined objectives and desired outcomes. To ensure cost-effectiveness, it is important to be clear about what needs to be regulated and why (see certainty principle above), and to consider all possible alternatives before imposing obligations likely to add significantly to the existing regulatory burden.

(b) Regulatory impact statements

A regulatory impact statement usually includes an assessment of the costs and benefits of each option, followed by a recommendation supporting the most effective and efficient option.⁵⁹ Impacts are viewed from an economy-wide perspective, taking into account the scope, scale and type of the impact.⁶⁰ This enhances transparency and provides investors with confidence that the regulator has accounted for investments costs prior to implementing policies or making decisions.

(c) Regular governance monitoring and review

The circumstances in which a self-governance framework operates will necessarily change over time. Regular monitoring of the framework’s processes and rules/actions will provide an indication of their effectiveness in meeting the objectives of the framework (e.g. to correct a market failure), and will therefore assist in maintaining the framework’s efficiency. By periodically reassessing the need for regulation and the appropriate response, it can be ensured that self-regulation continues to be cost-efficient.

The OECD Guiding Principles for Regulatory Quality and Performance provided that:⁶¹

Continual and far-reaching social, economic and technological changes require governments to consider the cumulative and inter-related impacts of regulatory regimes, to ensure that their regulatory structures and processes are relevant and robust, transparent, accountable and forward-looking. Regulatory reform is not a one-off effort but a dynamic, long-term, multi-disciplinary process.

58. COAG Principles, at 4.

59. Eg Australian Office of Best Practice Regulation, *Best Practice Regulation Handbook (Draft)*, November 2006, at 13-14.

60. Office of Best Practice Regulation, *Best Practice Regulation Handbook (Draft)*, November 2006, at 8.

61. OECD, *Guiding Principles for Regulatory Quality and Performance*, 2005, at 1.

COAG also notes the essential role of monitoring of regulatory arrangements:⁶²

It is essential that both the situation and the effectiveness of the response be closely monitored. Monitoring will determine whether:

- *the risk was under or over estimated and the response is adequate in the circumstances;*
- *the risk has changed and the response no longer applies to new circumstances; and*
- *those at which the action was directed are responding.*

If self-governance rules and actions are shown to be ineffective or if the circumstances (or an understanding of the circumstances) have substantially changed, then the self-governance processes should be reviewed for amendment or removal. Periodic review and evaluation of the design and operation of self-governance rules will ensure that these rules continue to meet the objectives of the self-governance framework and be justifiable to members. An open review process, if so chosen, will also give industry participants a regular chance for feedback on the operation of the framework.

Any monitoring and review framework, however, should be manageable, cost-efficient and not unduly intrusive on the participants in the framework. This is particularly so in self-governance systems due to the voluntary nature of membership by industry participants.

Sunset provisions, whereby a self-governance framework expires after a certain period of time unless further specific action is taken to extend it, are another option that could be included in purpose-specific self-governance frameworks. Sunset provisions enable a comprehensive review of the objects of the framework and its effectiveness in meeting those objects to be undertaken periodically to ensure that any self-regulation continues to be justifiable over time.⁶³

The length of any sunset provisions should also be considered carefully. If the time period is too short, industry participants will not take business decisions, say, to install new infrastructure that may be required under a particular self-governance framework. But if the sunset period is too long, the value in having a compulsory review will be undermined. As a general rule, the higher the cost to industry of installing new infrastructure to meet self-governance requirements, and the longer the period required to recover those costs, the longer any sunset period should be so that investment in that infrastructure is not discouraged.

(d) Building investment incentives into the self-governance framework

Self-governance arrangements should consider incorporating one or more of a number of the current governance practices available in order to ensure that there are adequate incentives for further efficient investment in payment systems. A cost-based self-governance framework could, for example, encourage investment by providing a risk premium, that is, an incentive to invest in riskier projects. Incentives can take a number of different forms, including an increased rate of return, regulation-free periods to enable the development of new infrastructure, or light-handed regulation.

Intrusive regulatory practices, such as the imposition of pricing regulation, may deter investment because of the high compliance costs involved and may also inhibit commercial negotiations. Light-handed regulation may avoid these pitfalls and may be most appropriate in markets where competition is only just emerging.⁶⁴

(e) Consideration of existing legal and regulatory framework

Payment systems self-regulation operates alongside central bank or other government agency oversight of payment systems. Therefore, to increase efficiency, self-governance frameworks should be designed to minimise duplication and conflict with the overarching legal framework.

With regards to financial regulation, the legislative framework is the mix of statutory, regulatory and contractual rules that govern the rights and obligations of parties to a transaction. In the context of payment systems more specifically, examples of framework legislation are the laws governing contracts, insolvency, banking, secured interests, and, in some instances, competition and consumer protection laws.⁶⁵ Specific laws governing particular aspects of the payments system (e.g. central bank powers, settlement and netting) will also be relevant.

Before new self-governance arrangements are developed, it would be advisable to seek legal advice to minimise any risk of conflict with existing legal obligations. Then, once the framework is implemented, self-governance arrangements could shift their focus to ensuring compliance with any relevant legal obligations applicable in the relevant jurisdiction. It may also be prudent to approach the relevant regulatory authorities before the framework commences operation. This will particularly be so if the self-governance framework is itself subject to compliance obligations.

62. COAG Principles, at 25.

63. COAG Principles, at 16.

64. Eg Australian Productivity Commission, *Review of the Gas Access Regime*, Inquiry Report No 31, 11 June 2004, at 331.

65. Bank for International Settlements, *Core Principles for Systematically Important Payment Systems*, January 2001, at 2.5.

Glossary

Actions

Together with rules, actions are the output of the governance processes. Actions include a wide range of rulings, requirements, conventions or activities that are designed to enforce the framework or make it operate effectively and smoothly. Examples include rulings to make and enforce the framework's rules, compliance programs developed by industry participants, and monitoring and auditing programs to ensure industry compliance programs are being followed.

COAG

The Council of Australian Governments.

Objectives

Purpose and policy goals of the governance framework. They answer the question: why are we setting up this framework?

Participants

Industry stakeholders who are involved with the self-regulation of that industry.

Payment systems

Systems that comprise a set of instruments, banking procedures and, typically interbank funds transfer systems that ensure the circulation of money.

Processes

Rules of engagement between the players, including the role of each and the procedures to be followed. They should articulate the powers, rights and obligations of each stakeholder. They must answer the questions: who will do what and how will they do it?

RBA

Reserve Bank of Australia, Australia's central bank.

Relevant regulator

Government regulator that has oversight responsibility for a particular industry.

Rules

Together with actions, rules are the output of the governance processes. They might include codes, operational standards and other protocols that govern how parties must act. Rules may also establish institutions to give effect to the governance framework.

Self-regulatory organisation (SRO)

A non-governmental body responsible for the supervision and regulation of its own members that may set its own rules and take actions that affect its members.

Self-governance framework

A form of industry governance where individual firms or industries regulate their own conduct by setting objectives and directions, formulating rules, standards and/or codes of conduct, and where industry may be responsible for enforcement.