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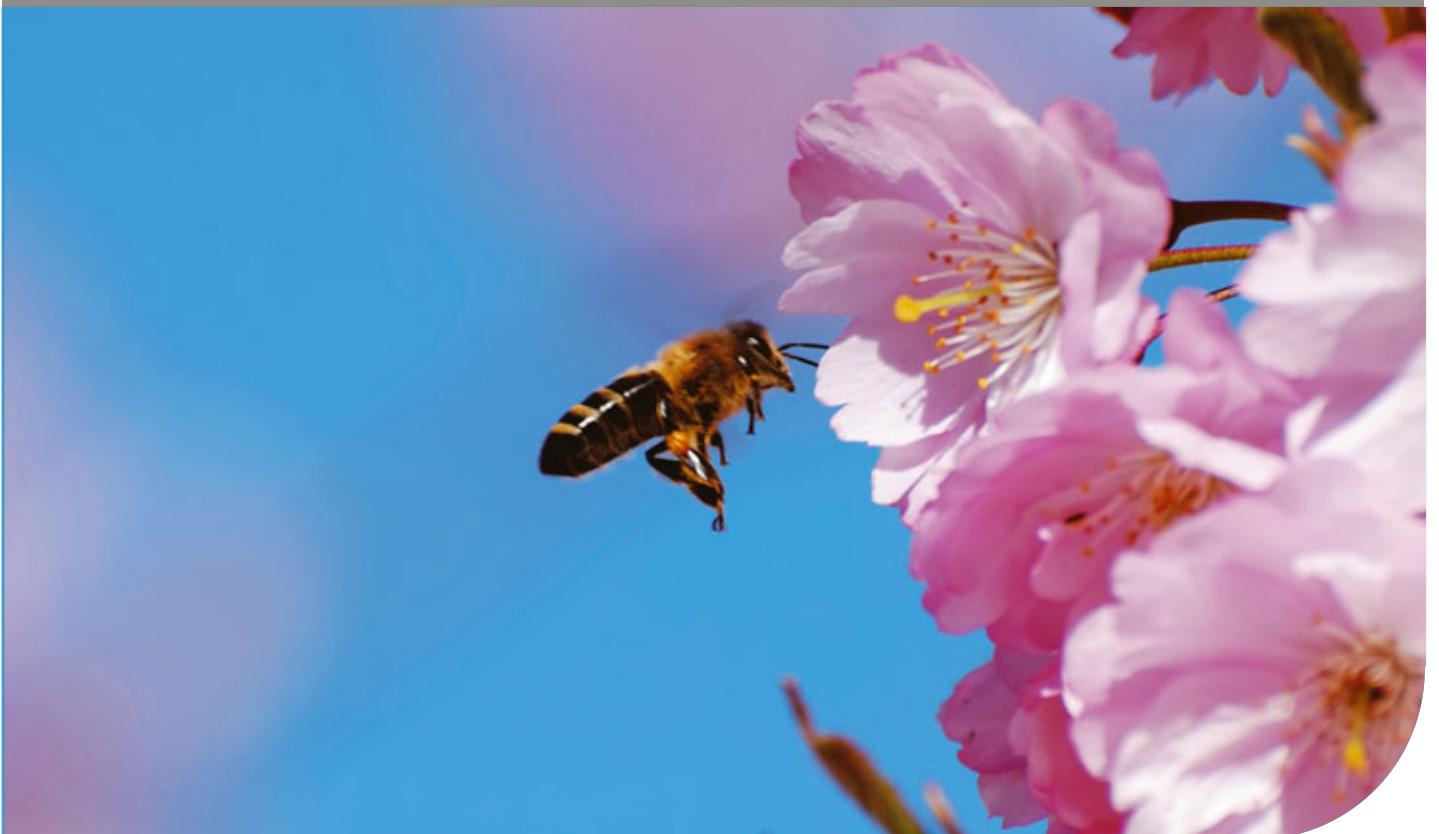
IN ENGLAND AND WALES

An initiative from the ICAEW

Society benefits when markets are efficient and when they deliver desired public policy outcomes. Such markets will have as their foundations **participants** that can trust and be trusted and accepted standards of **behaviour** that are promoted by effective and efficient **mechanisms**.

Do the foundations of our markets work efficiently together?

MARKET FOUNDATIONS



MARKET FOUNDATIONS

The need for effective and efficient markets

Society's prosperity depends on transacting in goods and services. This allows people to organise themselves to use their particular comparative advantages that result from factors such as specialisation, economies of scale, and uneven resource allocation. Goods and services are exchanged through markets and society's prosperity is enhanced when those markets deliver what the public wants from them efficiently and effectively, allowing the benefits of those comparative advantages to feed through into the economy.

Healthy markets have adequate numbers of willing buyers and sellers equipped with the information to make decisions and means of contacting each other to make exchanges. Buyers and sellers also need to be able to trust that the information is sufficient and reliable and that proposed transactions will be fulfilled on the terms agreed. With these features in place the potential buyers and sellers can make their own decisions and the operation of market forces should ensure that demand and supply move in response to each other. However, as well as a means of exchange, other mechanisms may need to be put in place to intervene in the process. This may be to:

- achieve specific requirements that society has decided should be imposed on those markets;
- correct faults in the underlying operation of the market infrastructure, often resulting from asymmetry of information or bargaining power; or
- create a market infrastructure in circumstances where resources were previously allocated by other means: for example carbon emissions, hospital usage, or radio frequencies.

The foundations of an effective and efficient market infrastructure are:

Participants

A sufficient number of **participants**, whether as principals wishing to buy or sell goods and services, agents facilitating the necessary deals, or advisers providing information. Participants can be individuals or entities given a legal existence to allow greater scale and sharing of risk and reward.

Participants influence and are influenced by **mechanisms**.

Mechanisms

By mechanisms we are going beyond the purely physical means of exchange, referring to those mechanisms sometimes needed to intervene in markets to correct actual or perceived failings.

The role of mechanisms in public policy outcomes is discussed in more detail in *Information for markets and society*, published by the Institute of Chartered Accountants in England and Wales' (ICAEW) in November 2005.

Mechanisms influence and are influenced by **behaviour**.

Behaviour

The conventions surrounding markets and the actions within them need to be predictable, transparent and to standards that inspire trust, a fundamental prerequisite of effective markets.

Such behaviour is considered in more detail in *Reporting with integrity*, published by the ICAEW in April 2007.





Evaluating market foundations

Market foundations are pivotal to the businesses that generate society's prosperity. However, they have often evolved as a natural but an ad hoc reaction to individual events.

We will be analysing these foundations to seek answers to key questions: What has developed well and why? What no longer works as efficiently for its current purpose as it might? What lessons can be learned to enhance market effectiveness and efficiency further and promote economic progress?

In analysing market foundations, we need to consider the interaction between **participants**, **mechanisms** and **behaviour**. Therefore we are proposing to cover different themes to illustrate or assess this interaction, together with the means by which it may be enhanced.

Themes on which reports are planned include:

The public interest

Market **participants** have a basic expectation that others they have to deal with should act in accordance with certain standards of **behaviour** and that these standards (and any **mechanisms** designed to influence behaviour) will have been set in the public interest. Where actions by market participants benefit them individually, there will often be an assumption that any spin-off effect will also be of public benefit.

Acting in the public interest

Our report will be looking at different views as to what the public interest is and how it is applied. Differences of opinion make it difficult to assess how the public interest is served when reconciling sometimes competing aims such as efficiency, fairness, cost and freedom of action within a regulatory infrastructure.

Professions

The complexities of transactions in many markets mean that those working in professions form a significant component of those market **participants** who advise and inform the trading principals. Professions, as well as comprising participants, also act as a form of intervention **mechanism** themselves as they seek to set higher standards of **behaviour**.

The role of professionalism

Our report will be considering the challenges facing society, to be sure that professions and professionals are able to provide what markets need from them but do so in an effective and efficient manner, in the public interest.

Legal entities

Individuals are the decision makers in all market transactions, however organised. However, when acting individually they cannot necessarily operate on a scale that effective and efficient markets demand and the risks they face without collective action can be prohibitive. Society has allowed individuals to work together through legal entities, which can act as market **participants** themselves, to address these issues.

The rights and duties of legal entities

Our report will consider the rights and obligations of legally created entities, which are necessarily set by law or regulation. They are influenced by and have an influence on intervention **mechanisms** and standards of **behaviour**. However they are not all set up in the same way and some are more effective than others.



In addition we will be expanding on existing ICAEW work:

Regulation

Regulation controls what market **participants** are allowed to do. It is an increasingly prevalent intervention **mechanism** and is designed to shape **behaviour**, either to correct market imperfections or direct market activities towards goals that society has set.

We will be looking to summarise and take forward work by the ICAEW and others on forms of regulation, its application in specific areas and assessment of its effectiveness and costs.

Ethical behaviour

Participants expect certain standards of behaviour but are in turn ultimately responsible for it. Ethical behaviour is based on a set of generally accepted and applied values and conventions. The degree to which there is ethical behaviour in markets has a direct impact on the need for intervention **mechanisms**.

We will be taking forward work by the ICAEW and others on issues such as whether the values and conventions underlying market **behaviour** are agreed, whether they can be applied across different market cultures and how accountability for their application can be enhanced.

Economic crime


In any market there may be undesirable **behaviour** by market **participants**. It is the role of many **mechanisms** to prevent or detect such actions.

We will be considering work by the ICAEW and others on, for example, anti-money laundering legislation and considering what lessons can be learned.

Our work on *Market Foundations* underpins the specific areas of activity covered by the ICAEW's other thought leadership programmes. The ICAEW has already advanced thinking successfully on a wide range of subjects including financial and business reporting, corporate governance, corporate responsibility and sustainability, business and professional ethics, audit quality and assurance services. Our ideas are presented internationally to governments, regulators, standard setters, business, investors and other opinion formers, including leading academic researchers and institutions.

Our work on *Market Foundations* starts from a wider base than the other programmes and will examine the scope for cross-fertilisation of ideas from different parts of the economy to enhance economic life generally. This will be particularly relevant in considering confidence in business, which depends on the interaction of many areas of economic activity.

We welcome input and discussion. If you would like to comment on the points raised in this paper, contribute to the ongoing work it refers to, or follow progress and receive copies of subsequent reports, please visit the ICAEW's website at www.icaew.com/thoughtleadership or email marketfoundations@icaew.com.



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The ICAEW's involvement

The ICAEW exists for the public benefit, according to its 1880 Charter of incorporation, to elevate and further the efficiency and usefulness of the accountancy profession.

The ICAEW is able to reflect widely varying perspectives and objectives. Our more than 129,000 members work in a wide range of influential roles and with all types of organisations, across the world.

The ICAEW utilises this breadth and depth of experience to analyse and challenge some of the assumptions and structures surrounding market foundations. We are looking to utilise the ICAEW's power to convene, bringing together relevant stakeholders to discuss matters of common interest and identify how what is so often taken as read can be improved, enhancing confidence in markets for the benefit of society.

Our work on thought leadership involves evidence gathering, analysis and the development of practical policy proposals and professional guidance. As a professional body and through our members, the ICAEW's work has authority because it incorporates a public interest stance, intellectual rigour and real world experience.

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