Exchange Regulation and Corporate Governance: A Basic Post-Crisis Roadmap

Guillermo Larraín R.
Chairman, Superintendencia de Valores y Seguros, Chile
Chairman, IOSCO Emerging Markets Committee

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Agenda and argument

• Why governance?
  – Growth and economic efficiency
  – The lesson from the crisis
  – Regulatory need in view of enforcement principles

• Why stock exchanges (SE)?
  – SE is an organized market, with its own incentives
  – Challenges to intentional governance view
    • Internal conflicts: asymmetries of information, reputation
    • External conflicts: various forms of competition

• Two challenges for SEs from IOSCO perspective
  – Standardization of derivative products (ie, CDS)
  – Market closures: understanding when, why, how long.
1. Promoting development of Stock Market is critical for economic growth

- Financial services provided by banks and non banking institutions are complementary, not substitutes.
- International empirical evidence is increasingly clear about this

Using panel data suggest that financial services provided by banks and capital markets are different and both contribute, independently, to economic growth.

Tabla 2: Tamaño y Liquidez de los Mercados

<table>
<thead>
<tr>
<th></th>
<th>Crédito Privado / PIB</th>
<th>Capitalización de Mercado Accionario / PIB</th>
<th>Turnover</th>
<th>Bonos Privados/PIB</th>
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</thead>
<tbody>
<tr>
<td>América</td>
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<td>Latina</td>
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<td>Estados Unidos</td>
<td>174</td>
<td>118</td>
<td>121</td>
<td>113</td>
</tr>
</tbody>
</table>

|                |                        |                                           |          |                    |
| Europa         | 100                   | 53                                        | 123      | 38                 |
| Italia         | 83                    | 37                                        | 121      | 44                 |
| Francia        | 88                    | 67                                        | 85       | 42                 |
| Alemania       | 117                   | 37                                        | 129      | 43                 |
| España         | 111                   | 71                                        | 157      | 24                 |

|                |                        |                                           |          |                    |
| Asia           | 98                    | 72                                        | 91       | 37                 |
| Japón          | 105                   | 60                                        | 87       | 44                 |
| Corea          | 120                   | 48                                        | 235      | 50                 |
| Malasia        | 132                   | 141                                       | 34       | 53                 |
| Filipinas      | 35                    | 40                                        | 9        | 0                  |

Fuente: Betancour et al. (2006) y cálculos propios de promedios para países en la muestra.
1. From corporate governance to aggregate economic efficiency

Governance is about residual rights of control. With incomplete contracts, it refers to the right to make ex post decisions in unspecified contingencies. This discretion can be used strategically in bargaining over surplus. Grossman and Hart (1986), Zingales (1998)

1. Distribution of the surplus generated by the firm affects ex ante incentives
   - The governance system must reward efforts properly in order to create value enhancing activities. Otherwise, agents will spend resources in inefficient activities to alter ex post bargaining

2. Inefficient bargaining
   - Governance can affect information asymmetry between parties, coordination costs.

3. Risk aversion
   - Governance should not add uncertainty to investors
2. What we need to learn from this crisis: governance is critical

The roots of this crisis are basically related to governance issues

- Issuers
- Institutional Investors
- Credit Rating Agencies
- Auditors
- SRO’s
- Supervisors

- Compensation policies
- Risk identification
- Risk management
- Conflicts of interest
- Weak enforcement
- Poor due diligence
3. Improving Governance is key as Principle-based regulation will continue.

**Role of Stock Exchanges**

- **Rules** vs. **Principles**
- **Quality of Governance**
- **EX ANTE OVERALL GOVERNANCE**
  - BAD
  - GOOD
  - "optimal"
  - SUB-OPTIMAL
  - NON-OPTIMAL
  - OPTIMAL
What does a Stock Exchange do?

Wikipedia: a **stock exchange**:
1. Is a **corporation** or **mutual organization** which provides "trading" facilities for **stock brokers** and **traders**, to trade **stocks** and other **securities**.
2. Provides facilities for the issue and redemption of securities and other financial instruments.

(a) Mobilize savings for investment (diversification)
(b) Corporates raise capital (risk sharing)

Stock market promotes productivity (resource allocation) and growth

An exchange, is a market, organized by their controllers under the framework of national laws and regulations

Understanding the incentives faced by controllers, the conflicts among them and/or their conflicts of interest is critical for understanding the nature of the market organization provided by the Exchange.
Exchanges and governance

National regulation

Stock Exchange

Corporate Governance

Regulation
Enforcement
Supervision

This transmission channel depends of the Stock Exchange’s governance structure itself
What is a Stock Exchange? Becomes, Why and how markets get organized?

- Markets with *spontaneous governance*, Invisible hand *works*
  - No market failures
  - Price mechanism operates for resource allocation
  - Reputational effects are significant

- *Intentional governance is needed* in financial markets:
  - Failures
    - Asymmetries of information *(inherent)*
    - Externalities
  - Poor liquidity, insider trading and market manipulation hamper the functioning of the price mechanism
  - Reputational effects are weak and expensive to indentify and monitor

Fuente: basado en Williamson (1991)
Improving intentional governance: some challenges for Stock Exchanges

Identify and credibly manage conflicts of interest among insiders and...

| • ... the general public                      | • ... other economic interests |
|                                             |                               |
|  – Supervision                               |  – Governance codes: do they exist? Are they incorporated into listing requirements? |
|  – Transaction rules                         |  – Public uneasiness about company’s practices? |
|  – Insider trading                           |                                           |
|  – Self dealing                              |                                           |

Asymmetries of information

Reputational Effects
From demonizing the State in the 90’s to wishing more… intentional governance

The role of SEs in improving intentional governance is key, but there are limitations that in some cases are not easily solved.

<table>
<thead>
<tr>
<th>Legal tradition</th>
<th>Competition with other industries</th>
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<tbody>
<tr>
<td>Mutualist stock exchanges</td>
<td>Demutualized stock exchanges</td>
</tr>
<tr>
<td>Competition (a) other financial centers, (b) alternative platforms</td>
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The crisis has shown that *(intentionally) organized* markets worked well. The international financial system needs:

(a) More products traded in SEs -> standardization of socially less valuable taylor made contracts

(b) More products cleared and settled in CCPs
IOSCO’s view on CDS market

International Swaps and Derivatives Association:
• Notional m-t-m OTC derivatives markets USD 600 TR,
  • After netting becomes USD 4 TR

1. Counterparty risk
   • CDS sellers, insufficiently capitalized. Poor disclosure

2. Lack of transparency
   • Inability to assess exposures, therefore risks
   • Market misconduct

3. Operational risk
   • Long standing problems (backlog of unconfirmed or unprocessed trades, acute in stress)

Central Counterparties for standardized CDS

Standardize OTC derivative products, CCP compatible
Emerging Markets Committee implemented a crisis task force: questionnaire

**FIRST PHASE**

1. **Financial**
   - Write-downs, capital losses
   - Fire-sales, retract credit lines
   - Sharp price declines, extreme volatility

**SECOND PHASE**

2. **Economy**
   - Export contraction
   - Slower domestic demand
   - Falling corporate profits
   - Increased default risk
   - Lower fiscal revenue

**THIRD PHASE**

3. **Social**
   - Retrenchment, unemployment
   - Social pressure, welfare issues
   - Loss of confidence

Risk exposure of capital market increases

**Feedback effects**
## IOSCO EMC Sample

<table>
<thead>
<tr>
<th>INTERAMERICAN</th>
<th>AMERC</th>
<th>ASIA PACIFIC</th>
<th>EUROPE</th>
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<tbody>
<tr>
<td>ARGENTINA</td>
<td>DUBAI (DFSA)</td>
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<td>BERMUDA</td>
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**Interamerican: North, South and Central America**

**Asia Pacific: East Asia and Oceania**

**AMERC: Africa and Middle East**

**Europe: Eastern Europe including Turkey**
Interventions have primarily focused on addressing threats to systemic stability.

- Exceptional financing from central bank
- Increasing deposit insurance limits
- Exchange rate intervention
- Capital flight controls
- Fiscal and monetary policies
- International financing arrangements
- Restricting short selling or other market interventions
- Trading halts or circuit breakers
- Temporary revision of securities market regulations
- Market closure
- Use of public resources to support stock prices
- Increased surveillance and enforcement of market intermediaries
- Methods for risk measurement.
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