



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

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- 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**
  - Levine & Zervos (1998)
  - Beck & Levine (2002, 2004)

**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*

	<b>Crédito Privado / PIB</b>	<b>Capitalización de Mercado Accionario / PIB</b>	<b>Turnover</b>	<b>Bonos Privados/PIB</b>
<b>América Latina</b>				
Argentina	12	62	6	10
Brasil	33	36	32	10
Chile	75	86	10	19
México	18	18	21	3
Colombia	23	15	3	0
<b>Estados Unidos</b>	174	118	121	113
<b>Europa</b>	100	53	123	38
Italia	83	37	121	44
Francia	88	67	85	42
Alemania	117	37	129	43
España	111	71	157	24
<b>Asia</b>	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

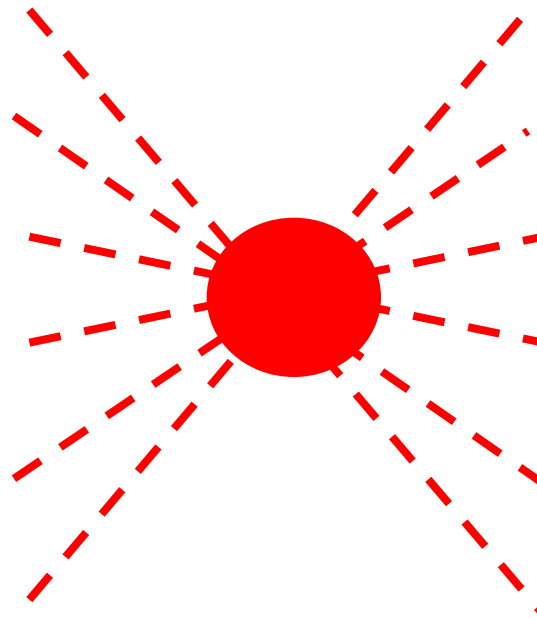
Institutional Investors

Credit Rating Agencies

Auditors

SRO's

Supervisors



Compensation policies

Risk identification

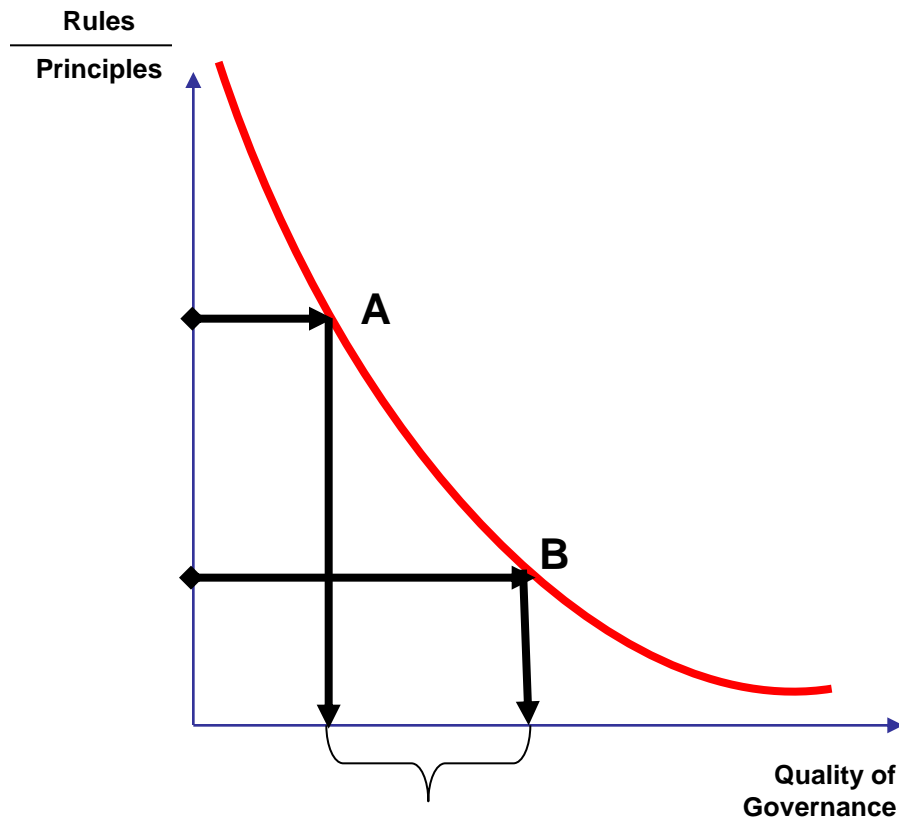
Risk management

Conflicts of interest

Weak enforcement

Poor due diligence

# 3. Improving Governance is key as Principle-based regulation will continue



Role of Stock Exchanges

EX ANTE OVERALL GOVERNANCE

		BAD	GOOD
REGULATORY EMPHASIS	Rules	"optimal"	SUB-OPTIMAL
	Pples	NON-OPTIMAL	OPTIMAL

The table is a 2x2 matrix. The vertical axis is labeled 'REGULATORY EMPHASIS' with 'Rules' at the top and 'Pples' at the bottom. The horizontal axis is labeled 'EX ANTE OVERALL GOVERNANCE' with 'BAD' on the left and 'GOOD' on the right. The top-left cell (Rules/BAD) contains the text '"optimal"'. The top-right cell (Rules/GOOD) contains the text 'SUB-OPTIMAL'. The bottom-left cell (Pples/BAD) contains the text 'NON-OPTIMAL'. The bottom-right cell (Pples/GOOD) contains the text 'OPTIMAL'. A red arrow points from the 'SUB-OPTIMAL' cell to the 'NON-OPTIMAL' cell. A green arrow points from the 'SUB-OPTIMAL' cell to the 'OPTIMAL' cell. A green curved arrow is at the bottom of the 'OPTIMAL' cell.

# 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.



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

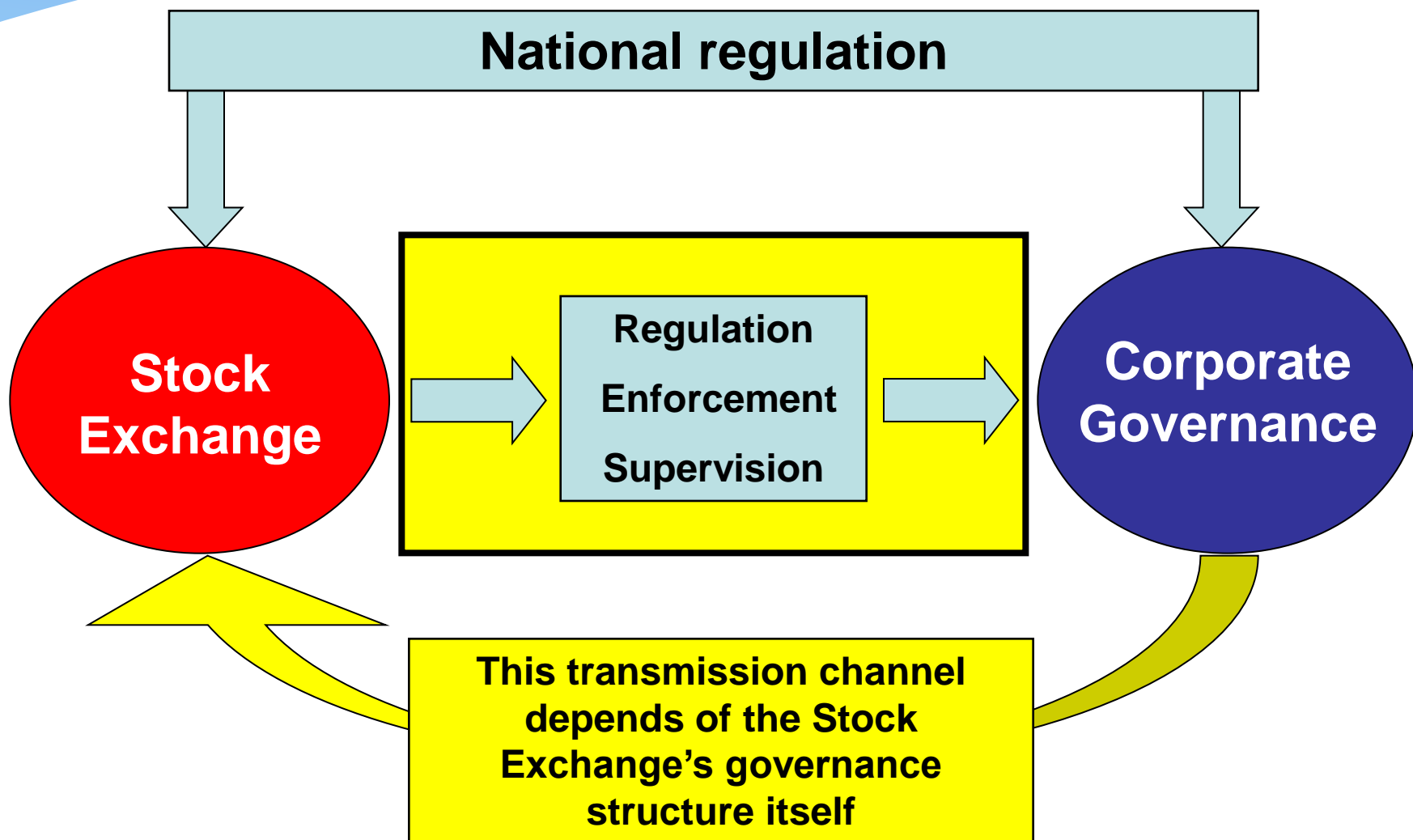
(a) Mobilize savings for investment (diversification)

(b) Corporates raise capital (risk sharing)

Stock market promotes productivity (resource allocation) and growth



**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.**





# 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

# Improving intentional governance: some challenges for Stock Exchanges



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

- ... the general public
  - Supervision
  - Transaction rules
  - Insider trading
  - Self dealing

- ... other economic interests
  - Governance codes: do they exist? Are they incorporated into listing requirements?
  - Public uneasiness about company's practices?

Asymmetries of information

Reputational Effects

# From demonizing the State in the 90's to wishing more... intentional governance



Intentional governance is wider than just State regulation

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

Legal tradition

Competition with other industries

Mutualist stock exchanges

Demutualized stock exchanges

Competition (a) other financial centers, (b) alternative platforms

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



## 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

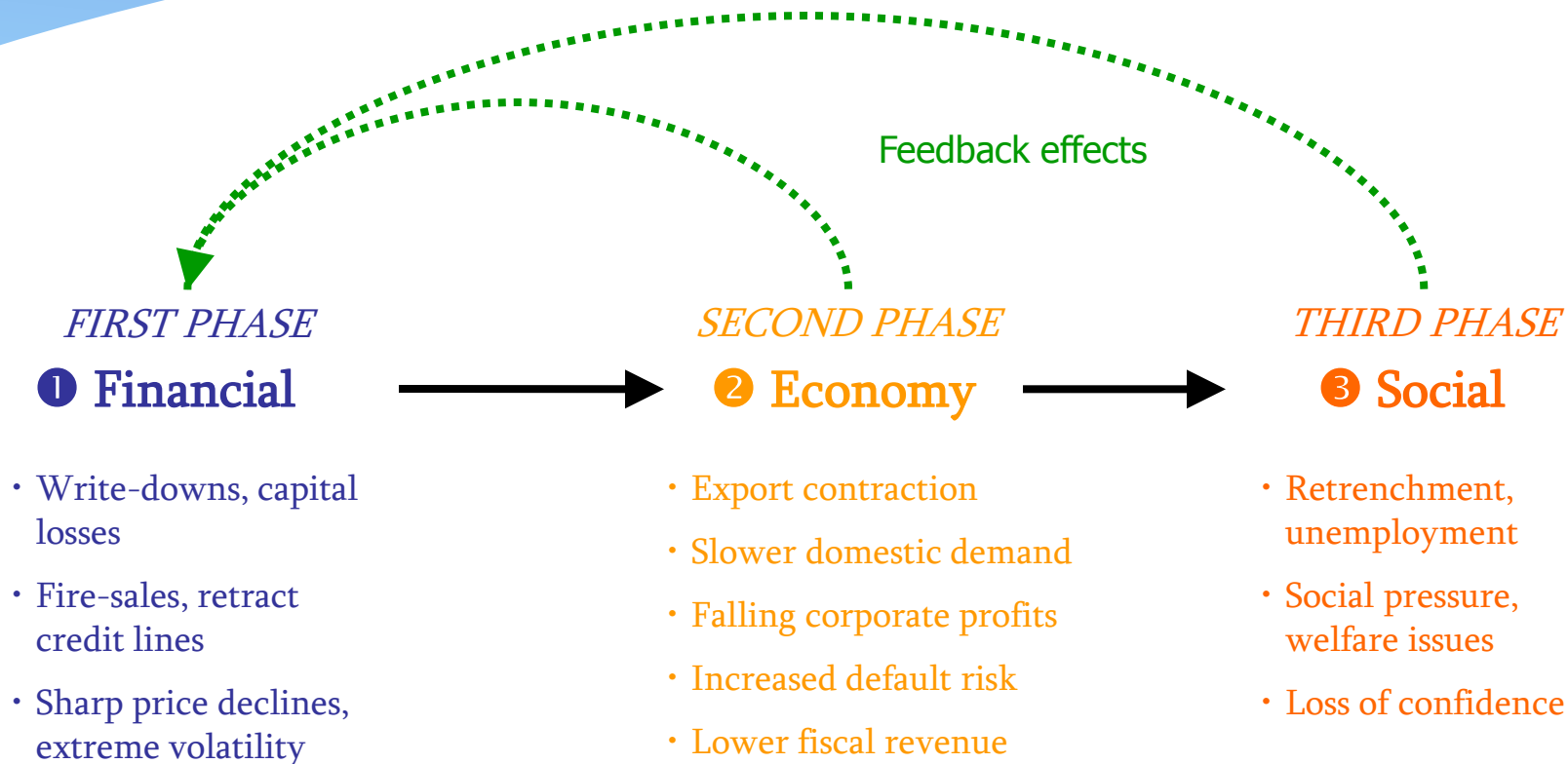
### 3. Operational risk

- 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



# IOSCO EMC Sample



<b>INTERAMERICAN</b>	<b>AMERC</b>	<b>ASIA PACIFIC</b>	<b>EUROPE</b>
ARGENTINA	DUBAI (DFSA)	CHINA	CZECH REPUBLIC
BERMUDA	EGYPT	INDIA	HUNGARY
BRAZIL	GHANA	INDONESIA	MACEDONIA
CHILE	ISRAEL	MALAYSIA	MONTENEGRO
COLOMBIA	MOROCCO	MONGOLIA	POLAND
COSTA RICA	NIGERIA	PAKISTAN	ROMANIA
ECUADOR	OMAN	PAPUA NEW GUINEA	SLOVENIA
URUGUAY	SOUTH AFRICA	SOUTH KOREA	TURKEY
	TUNISIA	SRI LANKA	
	UNITED ARAB EMIRATES	TAIWAN	
	WMA	THAILAND	

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





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