



# **CORPORATE GOVERNANCE, MARKET INTEGRITY AND INVESTOR PROTECTION**

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**Presentation in the KNUTE roundtable:**

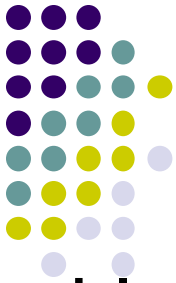
**“Regulation of financial market services in the environment of global imbalances”**

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**KNUTE, Kiev**



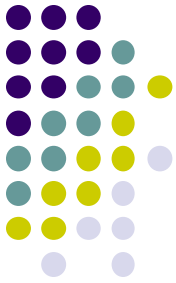
# INTRODUCTION



## Market integrity and capital market development

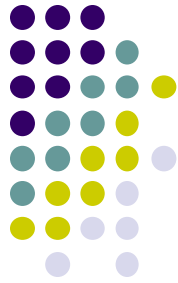
- The establishment and maintenance of **market integrity** is a crucial prerequisite of **capital market development**.
- In the modern world of global imbalances, the ensuing **uncertainty cannot be controlled by the individual market**, so the solution is **either** a control of in/outflows **or** the enhancement of market integrity [**“closed” vs. “open” but credible markets**].
- **On the demand side of the market function**, the ability of a market to attract investors and obtain liquidity is predicated on its capacity to acquire both the **essence** and the **reputation** that it is a **fair** and **efficient** market that protects the *bona fide* interests of investors.
- **On the supply side of the market function**, the ability of a market to attract issuers and provide **fair pricing** for the securities traded in it is vital for the **protection of the interests** of actual/potential issuers.

Recall: The fundamental developmental contribution of a capital market is the provision of fair finance to companies.



## Market integrity and investor confidence

- Market integrity arises as a very important aspect of the corporate financing function, since fair, transparent and competitive **pricing** is expected by issuers and must be provided by an efficient market.
- **Market integrity** is therefore a condition that maintains the **confidence** of both investors and issuers in the market mechanism.
- Consequently, the **safeguarding of market integrity** is a necessary element in any **strategy for capital market development**



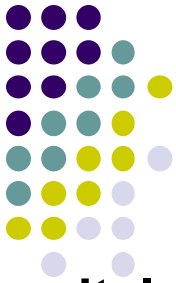
## Market integrity and investor confidence

- The market integrity encloses a variety of items such as:
  - the safety of transactions and of investor assets;
  - protections against default of financial firms (intermediaries);
  - equal access to investment services (financial inclusion);
  - fair execution of investor orders.
- An important aspect of market integrity relates to the **elimination of market abuse** by parties who have a **privileged position** in the market system.
- The establishment and maintenance of market integrity can be achieved by a combination of measures and policies, which include:
  - centrally enforced rules** by capital market authorities
  - arrangements** put in place and enforced by the **issuers** of securities.
- In that respect, corporate governance of issuers in the capital market becomes directly **linked** to market integrity.



## The notion of corporate governance

- **Corporate governance** has been an object of intense reflection on the **structure and control of publicly held companies**.
- The concept of '**Corporate Governance**' is used to describe the **system of rules and procedures employed in the conduct and control of listed companies**, with the view of **striking a proper balance between accountability and enterprise**.
- It is well known that corporate governance analysis does **not seek to impose rigid and uniform models of governance**.
- Its objective is to contribute to the **optimization**, within the new international environment, of **corporate performance** and to properly favor the interests of those (stakeholders) involved in the work of the company - investors, creditors and employees.



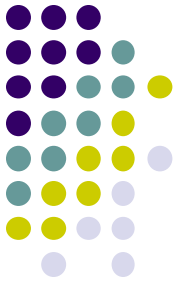
## Corporate governance and market integrity

- The corporate governance issue has gained diffusion in int'l capital markets as a response to the universal question of developing **adequate and efficient corporate control mechanisms**.
- The most important mechanisms are: (a) the role, structure and composition of the board of directors; (b) the corporate insiders' compensation schemes; (c) the role and market behavior of institutional investors; (d) the protection of shareholder minorities; (e) disclosure and transparency; and (f) corporate takeovers.
- Corporate governance has an **internal** and an **external aspect** of control:
  - internal control** is understood as the set of **organizational rules** within each listed company;
  - external control**, in turn, relates to the **relationship** of the company with external actors and the assessment of the performance of the company.
- All these items have an impact on market integrity.



## Corporate governance and the globalization of markets

- The globalization of capital markets imposes additional strictures on the organization and function of capital markets:  
**Liquidity & capital may travel between markets, so what flows in, flows out;**  
**International and domestic institutional investors, and even retail investors, evaluate markets and market opportunities across frontiers; and**  
**Issuers of securities evaluate funding opportunities across frontiers.**
- In this very competitive global context, a **lapse** in **both** the **level** and the **perception** of market integrity may prove very **costly** for a developing market, as it may drain it of liquidity and may spark an exit of capital, and a drying up of the supply of securities.
- Thus, in the present global environment, a **level playing field** is required both in terms of:  
**arrangements** that safeguard **market integrity** and,  
more specifically, in terms of **corporate governance arrangements** for publicly traded companies.



## Corporate governance and investor protection

- The shareholders of a publicly traded company deserve a necessary level of:
  - corporate protection, so that they can **exercise their shareholder rights** in the making, execution and evaluation of corporate decisions; and
  - market protection, so that they **can exercise their market rights to buy and sell shares** in a fair trading environment.
- The two sets of protection standards **overlap** and form the **interface** between corporate governance and market integrity.
- On balance, three basic aspects of this interface are taken up:
  - Corporate disclosure
  - Internal company arrangements relating to market integrity, and
  - Rules for the behavior of major shareholders in publicly traded companies.





## Disclosure of financial information and corporate dealings I

- The provision of **information** is crucial for corporate market valuation. Its timeliness, accuracy and general quality are essential for fair pricing and smooth market operation. The supply of information is categorized as follows:
  - a) **Regular financial & activity information, which is issued by the firm.**

This should comply with high quality, uniform and overtime consistent **accounting standards**, such as the IAS / IFRS. Besides the usual accounts, **cash flow statements** should be included in financial reporting.

Activity information disclosed in **Annual Reports** should also be high quality, comply to standards of **objectivity**, and adopt a content & exposition that is similar to the **Prospectus** issued when new securities are placed in the market. The exposition of **risk factors** must always be included.

The content of information disclosed must be the **same in all respects** whenever different disclosure channels are utilized.

**Selective disclosure must be eliminated.** Information provided to analysts, institutional investors etc must be made **widely available at the same time.**



## Disclosure of financial information and corporate dealings II

### b) Disclosure of information on important corporate events

Corporate events that are **relevant (i.e. price-sensitive)** and may exercise an effect on investor decisions must be disclosed rapidly so that they become known to actual / potential investors **symmetrically**, and avert the **abuse** of privileged information.

A **balance** must exist between **premature** and **delayed disclosure** in the case of events that take shape **overtime**.

A **policy on earnings and performance announcements** must exist so that these disclosures are **consistent overtime** and do not themselves become causes for speculation and mispricing of securities.

A **policy** must be in place for the response to **market rumors** about corporate events. This policy must provide a **balance** between **accurate disclosure** and **entrepreneurial confidentiality**.



## Obligations and restrictions on major shareholders

- A **corporate culture of equal shareholder treatment** must be built on the foundation of elimination of market advantage for corporate insiders.
- **Major shareholders and corporate officers** who are in a position to obtain privileged information must therefore be **subject to specific rules of market conduct and disclosure**.
- There is a wide menu of possibilities in this area:
  - Trading restrictions during **'sensitive periods'**,
  - Periodic reporting of **voting security holdings / ex-post announcement of executed trades**,
  - Ex-ante announcement of large trades** (by insiders) to the board of directors or to the market,
  - Disclosure of profits** from trades on the securities of the company.



## Internal organization of issuers

- The **internal organization** of issuers must be adequate to carry out the functions required by standards of governance and integrity.

The board of directors must **include in its responsibilities control functions** which oversee the **discharge of corporate obligations** with respect to minority shareholders, potential investors and the market in general

An efficient **compliance function** and **internal auditing procedures** should be established. The **compliance officer** should be adequate to the task, independent, and provided with means to perform his duties. Internal audit should occupy itself with compliance to both market and corporate rules.

**Restrictions** should be imposed on the **maintenance of confidentiality** within the firm so that **inside information does not circulate uncontrolled** within the firm and is **not abused** by corporate insiders.

The **list of corporate insiders with privileged information must be kept short**, and must include those who provide professional services as outside experts or contractors. Confidentiality agreements must be used.

A **shareholders' service unit should be established** for the support of small shareholder needs, information, participation in corporate functions, financial activities (share registrations, exchanges, capital increase etc.)



### Promotion of ratings and self-regulatory practices

- The ability of a market system to develop depends on a **crucial balance**.  
**On one hand**, market integrity must be established and maintained.  
**On the other hand**, entrepreneurial initiative, innovation, competitive advantage must be encouraged.
- It is easy to '**over-regulate**' a system to the point of repression of entrepreneurship and *bona fide* risk-taking.
- For that reason, **strategies for market development** must combine **external regulation** with **self-regulatory initiatives**:  
**Internal codes of conduct** can be an efficient and flexible tool for the development of corporate practices, consistent with market integrity.  
**Competitive third-party ratings** must be established and announced. The rating of listed companies on issues of corporate governance, protection of minority shareholders, corporate disclosure can prove to be a powerful tool for achieving compliance with high standards of market integrity.

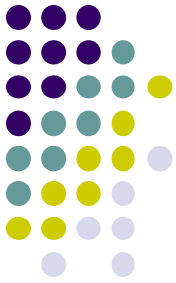


## Protection in corporate restructuring

- Shareholder rights in **major corporate restructuring** cases (**mergers, takeovers, spin-offs**) are also crucial for market development.
- Again, a **balance** must be sought between the **facilitation of efficient restructuring** and the **protection of minority shareholders**.
- A number of the mechanisms that were mentioned before, **e.g. the disclosure of major corporate events**, come into play in the case of corporate restructuring as well.
- Three important aspects must however be underlined here:
  - Any **market bids** for traded securities should be **extensive** enough to allow fair chances to minority shareholders to **'exit' at a fair price**.
  - Decisions to **merge or make a market bid** must be made by bodies that include some **representation of wide shareholder interests**.
  - All **proceedings for corporate restructuring**, once decided, must be subject to high standards of **disclosure**. This is also required for the **'defensive measures'**, which are used by incumbents to avert unfriendly bids.



# CORPORATE GOVERNANCE & MARKET INTEGRITY



## Conclusions

- **Market integrity is a fundamental ingredient of market development.**
- **From the perspective of firms whose securities are traded in organized markets, there is a very important interface between market integrity requirements and corporate governance arrangements.**
- **The measures, which promote market integrity, must be implemented with a sense of balance but also with sufficient force and uniformity so that they maintain confidence in markets.**
- **Market integrity is key to international credibility of the domestic market.**

**Thank you.**