CORPORATE GOVERNANCE, MARKET INTEGRITY AND INVESTOR PROTECTION

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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

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, <u>corporate governance</u> of issuers in the capital market becomes directly linked to <u>market integrity</u>.**

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.

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.