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PLENARY 5
Implementing Global Regulatory Principles and Standards

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A Development Agenda for the Emerging Market

It is a great honor to be invited to participate on a panel discussing a topic of such importance for the emerging markets. The International Finance Corporation, as part of the World Bank Group, has long supported the development of sound and effective financial institutions and capital markets in our client countries. We are strong believers in the principle that good regulation goes hand in hand with successful market development. That is why IFC has been an affiliate member of IOSCO since its founding.

International standard-setting is nothing new to IOSCO. Throughout its history it has brought together regulators from both developed and emerging markets to address issues of common concern and to endorse standards applicable to its entire membership. Its Emerging Markets Committee, which has nearly doubled in the past decade to around 70 jurisdictions today, is a forum unique among international organizations. It gives representatives from markets at all stages of development the opportunity to share experiences and learn from each other.

What IS new is the attention the international Community is now paying to organizations like IOSCO that are engaged in developing and promoting the adoption of international standards. Much of the recent focus on international standards has been within the context of initiatives to reduce systemic risk, both at the national and global levels. The importance of financial stability cannot be overstated. At the same time, for the substantial majority of the countries that are members of organizations like the IMF, the World Bank Group or IOSCO, we must remember that the over-riding priority remains the development of their financial systems.

The emerging markets need Financial systems that perform 4 key functions:

- Provide access for their most dynamic businesses to the global capital markets
- Mobilize domestic savings through sound, diversified investment options for their citizens
- Expand access to finance by their small and medium enterprises - often the backbone of their economies
- And extend financial services to the underserved, especially the urban and rural poor.

This is a daunting agenda for most emerging markets, because it entails building a number of effective institutions, both public and private, sometimes from scratch. And we know that institution-building is not just enacting reforms with the stroke of a pen. It's a long-term job that involves changing basic attitudes and expectations and fundamental behaviors. Given the scarcity of human resources in many emerging markets, it also often requires long-term investment in human capital.

What makes it even more challenging today is its urgency. The global revolution in both information technology and Financial services is making itself felt in even the least developed markets. In the past few months we've heard a great deal about a “digital divide” - the risk that communities, nations and even entire regions of the world will be left out of the so-called new economy. I know that many of the regulators in this room are equally concerned about a "capital divide" - the risk that their markets will be marginalized in the global system and not sufficiently developed to provide the financial services their companies and citizens require.

Their response to the threat of a capital divide must be two-fold, as you have heard earlier this week from representatives of jurisdictions such as Thailand and Singapore. They must build stronger local institutions and markets while at the same time improving the ways their financial systems are integrated with the global system. Among the most important tools available to meet this dual challenge are the sound practices reflected in international standards such as IOSCO's objectives and principles. In response, the international community should put the "development agenda" of emerging markets squarely at the center of efforts to promote the implementation of international standards.

There is no one-size-fits-all recipe for implementation, given the extreme diversity of the emerging markets. There are, however, some common factors. And since 1 couldn't resist alliteration, they're what I'll call the 3 "Cs" of implementation: context, capacity and chance.

Let's start with context. By this I mean that the way each country will implement international standards will depend on the country's economic and market structures.

The first reason why context is important is that it helps to select which international standards should be priorities. Most emerging markets simply don't have the resources to work on all areas simultaneously. There will be some standards that are more important than others for a country's market development - either because they address an area of special risk or because they deal with an important part of the financial system that remains underdeveloped.

For example, a country with a low savings rate and weak banking system might not put mutual fund regulation at the top of its priorities - unless, that is, it was threatened with pyramid schemes. In that case, valuable guidance could be found in IOSCO's principles and in much of the technical work of IOSCO's committees on Collective Investment Schemes.

The second aspect of context is market structure. This determines how a given international standard can be implemented, because it defines the incentives, behaviors and institutions that are the starting point. Another way of saying the same thing is - if the problem is different from country to country, then it's a pretty safe bet that the solution will differ as well.

The question of market structure is critical in areas like corporate governance, where achieving international standards depends on so much more than enacting standard rules. The basic dilemma of corporate governance is how to balance the interests of insiders and outsiders - so the insiders have sufficient incentives to run the company well, and so the outsiders are protected against insiders' abuse. Within any given country, the typical structure of corporate ownership will determine who are the insiders, who are the outsiders, and how they relate to each other. In order for mechanisms that protect outsiders to be effective, they will need to be tailored to the country's particular ownership structure.

To illustrate, let's take three examples of different market structures.

- In a market like the US, where widely dispersed ownership is common, the typical problem is how the shareholders, none of whom has a majority, can control the behavior of the company's managers. Not surprisingly, in North America and the UK, attention has focused on procedural rules that govern the composition and conduct of boards of directors and that strengthen their control over managers.
- However, in other markets where large family-run corporations are common, the family majority is often reluctant to share significant profits with outside investors or otherwise be accountable to them. In this case, a high priority is to give the minority clear legal rights to limit the family's ability to use their control position to extract profits.
- Finally, in a transition economy where insiders have strong incentives to strip assets or otherwise dilute outsiders at the expense of the company, and where judicial institutions are at best inexperienced, the most effective response may simply be an absolute prohibition on certain types of transactions that make it easy for insiders to disguise self-dealing.

There are common international standards of protections for outside shareholders that should apply in all three cases. But to implement those standards will require a different approach in each case.

Securities regulators are especially sensitive to the specifics of market structure. Markets are always evolving, and regulators are more often than not running to catch up. The extreme diversity of market structures across the members of IOSCO was one of the great challenges for IOSCO in drawing up its objectives and principles. If they were too general, they wouldn't serve their purpose, which is to articulate objective standards to which the entire membership is committed. On the other hand, if they were too specific, either they would only apply to a handful of the most developed markets or they would be out of date before they were finished.

Even in a static world, this would be an unenviable task. But as we've heard over the past few days, recent developments like Internet trading, ECNs and demutualization are having profound effects on the structure of secondary markets, the role of intermediaries, and cross-border transactions. They are presenting new challenges for disclosure regimes and investor protection. And they are even raising core questions regarding the jurisdiction and functions of regulators and self-regulatory organizations.

Consequently, the notion of context, my first "C" of implementation, is equally applicable to all members of IOSCO, not just its emerging markets members. The context for implementing the IOSCO principles is constantly changing and the pace of change is, if anything, accelerating. Unfortunately, it is safe to say that implementation will be a never-ending process for IOSCO's members.

The second "C' of implementation is <u>capacity</u>. This is especially important for the emerging markets. In order to implement international standards such as the IOSCO principles, a country must have the institutional capacity to make rules, implement those rules, and ensure compliance with the rules. We all know how the institutional configuration of securities regulation differs quite sharply form country to country, often as much a result of historical accident as design. Regulatory functions may be found in statute, regulation, rules of private associations or industry groups - whether or not officially recognized as SROs - or simply local market behavior.

Many emerging market regulators have severely constrained resources if they want to build regulatory functions within their own agency - due to limits both on overall budget and the level of salaries they can pay their staff. Therefore, they need to focus on professionalizing their operations in a few key areas where they can have the biggest impact on how the market players behave, and rely as much as possible on market incentives to supply other disciplines.

- For example, a securities regulator might decide to focus on ensuring a high degree of transparency - such as disclosure by issuers - so that investors can discipline issuers who perform poorly. This regulator might leave supervision of broker-dealers up to the stock exchange, if the exchange has sufficient commercial incentives to ensure that broker-dealers maintain adequate capital and meet minimum operating standards, such as links between client accounting and the exchange's trading and settlement systems.
- By contrast, another regulator might decide to structure its capacity differently. It could build its own regulatory operations to supervise the financial condition and operations of the stock exchange and brokers while leaving to the exchange the oversight of issuer disclosure and de-listing of poorly performing issuers.

The purpose of these two examples is not to advocate either but simply to underline the fact that there is no right way to implement international standards. I was interested to hear Howard Davies yesterday describing how the FSA is fundamentally rethinking the ways it can best perform its core regulatory functions and, in his analysis, going through tradeoffs similar to those I just described for an emerging markets regulator. But the limited institutional capacity of many emerging markets will often force them to make tradeoffs that are even more stark. And each jurisdiction has to find the most effective way to use both its public and private sector institutional capacity to meet the parallel objectives of developing its markets and improving regulation.

The third "C" of implementation is chance, otherwise known as a “window of opportunity.” Implementation of international standards is likely to require a great deal of complex institutional change, but change rarely works if it is simply dictated from the top down by policy makers. Reforms are most effective when a consensus for change is shared across a wide spectrum of a society in both the public and private sectors. And given that change usually threatens vested interests, it often requires a pretty powerful impetus for a true consensus for change to emerge. One force for change is when one country sees its neighbors reforming their markets and fears being left behind. This will undoubtedly be a continuing motivation for many emerging markets as they see themselves having to compete in a new, unpredictable and global knowledge-based economy. But an even more powerful force for change is the aftermath of a major financial scandal or crisis - a favorite example is of course the enactment of the US securities laws following the 1929 market crash.

The various crises that have hit emerging markets in the past few years may be presenting a similar chance for change. As Tharman Shanmugaratnam of Singapore described so clearly in his remarks yesterday, the economic disturbances in Asia have been an impetus for reforms that are critical if Singapore and its neighbors are to complete the development of their incomplete financial systems and market infrastructure. And in that context, the implementation of international standards - whether in accounting, corporate governance or securities regulation - is a key development priority for which we must hope the time is ripe.

Thank you very much.