Development of Emerging Capital Markets: Opportunities, Challenges and Solutions

Final Report

The Growth and Emerging Markets Committee
OF THE
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

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Contents

Chapter 1. Executive Summary 1
Chapter 2. The Role of Capital Markets and Its Impact on Emerging Markets 3
Chapter 3. Gaps in Capital Markets Development 7
Chapter 4. Addressing the Gaps in Capital Markets Development 11
Chapter 5. Implementation Challenges in Emerging Markets and the Role of Capacity Building18
Chapter 6. COVID-19 specific challenges for Emerging Economies.......... 21
Chapter 7. Conclusion and Recommendations 33
Annex 1: List of Acronyms.......... 38
Annex 2: List of Charts.......... 40
Annex 3: GEMC mandate and drafting team.......... 41

Chapter 1. Executive Summary

Well-functioning and liquid capital markets assist in capital formation and economic growth. In a study published in December 2019, for example, the World Bank confirms that "*a strong correlation has been found between capital markets and economic growth*" and points to "*the increased attention given to capital markets as a mechanism that can potentially help channel private sector funding to key strategic sectors of the economy, from corporates to infrastructure, housing, small and medium enterprises, and climate change*." [1] Indeed, the development of sound and robust capital markets is a topic of relevance for many growth and emerging markets as well as for international standard setting bodies, such as IOSCO.

At its February 2020 meeting, the G20 stated that "[a]ccelerating efforts to develop domestic capital markets is essential to support growth and enhance financial resilience and inclusion." In this regard, the G20 has prioritised the need to achieve an accessible and inclusive domestic capital market. Accordingly, the G20 Saudi Arabia Presidency through its International Financial Architecture Working Group (IFA WG) arm has included the development of domestic capital markets as a key element of its agenda, together with issues such as digitalisation and new technologies, financial inclusion and regulatory and supervisory aspects for the digital era.

The IOSCO Growth and Emerging Markets Committee (GEMC) was invited to contribute to the first objective of the IFA WG work program for 2020 which aims to develop domestic capital markets to support growth and enhance financial resilience. Although there is no *one size fits all* solution with regard to the development of capital markets, the report sets out several recommendations for emerging markets jurisdictions (EMs) to consider as they develop their capital markets.

The report is underpinned by extensive work that has taken place, across the years, at IOSCO via its GEMC. It discusses both the challenges and opportunities for EMs and sets forward a list of key recommendations for EMs to consider when developing their markets.

The report is structured around seven chapters, beginning with an executive summary under Chapter 1. Chapter 2 discusses the role of capital markets in market development along with a brief analysis of the capital markets in EMs. Chapter 3 addresses the main gaps identified in development of capital markets in EMs, while Chapter 4 discusses how to address those gaps. Chapter 5 sets forth the implementation challenges in EMs and the role of capacity building while Chapter 6 provides specific challenges presented by COVID-19 for EMs.

Finally, Chapter 7 sets out the following five key recommendations regarding capital markets development for EMs:

- **Recommendation 1:** Policy makers and regulators should develop a holistic strategy for the development of capital markets.
- **Recommendation 2:** Regulators should seek to ensure that capital markets are fair and efficient for capital raising. Increasing institutional investor participation, providing

[1] *Capital Markets Development: Causes, Effects, and Sequencing*, World Bank, December 2019, p 5, available at: https://documents.worldbank.org/en/publication/documents-reports/documentdetail/701021588343376548/capital-markets-development-causes-effects-and-sequencing

diversified investment choices, and ensuring market confidence should be high priorities on their agenda.

- **Recommendation 3:** Securities regulators should have adequate powers, proper resources and the capacity to perform their functions and exercise their powers.
- **Recommendation 4:** Jurisdictions should establish strong national and international cooperation arrangements to develop capital markets with the key involvement of the securities regulator.
- **Recommendation 5:** Regulators and market participants should develop and implement efficient roadmaps for investor education and guidance.

Chapter 2. The Role of Capital Markets and Its Impact on Emerging Markets

Deep, liquid, and well-regulated capital markets are instrumental in financing the economy and are the foundation for a thriving private sector -- a key driver of jobs and growth. As noted by the World Bank, well-functioning capital markets "[…] *help ensure the financial system's efficiency, stability, and risk management, preventing costly crises and helping channel savings toward capital that is essential for economic development and poverty reduction."* [2]

Indeed, deep and well-developed capital markets can play a variety of roles that are beneficial to the economy. In addition to providing more diverse sources of funding to real economy participants, thereby providing competition to bank finance, market-based finance can also encourage banks to increase their efficiency and lower the costs of bank capital. This, in turn, can encourage banks to increase their lending capacity, including to SMEs.[3] Finally, well-developed capital markets can also play an important role for households and firms themselves, allowing them to invest for the future or better manage their risks via hedging opportunities they may otherwise not have had access to.

In that context, market-based finance plays an important role in both providing access to short term funding needs – for example via money markets – and promoting opportunities for long-term or patient capital to support the global economy and efforts to drive sustainable long-term growth, via equity and debt markets. [4]

The importance of capital markets generally and the role market-based finance could play in "*providing a viable alternative to bank financing"* as noted by the IOSCO report on ***Market-Based Long-Term Financing Solutions for SMEs and Infrastructure*,**[5] became more evident following the 2008 Global Financial Crisis (GFC).

Indeed, as the main traditional supplier of Long-Term Finance (LTF), the banking system underwent a series of structural reforms aimed at improving their resilience, which caused them to withdraw from riskier lending activities, thus leaving corporates globally with the need to seek alternative sources of funding. At the same time, monetary policies implemented in developed jurisdictions to rescue domestic economies led market-based participants to seek investment opportunities further afield in a search for yield, thereby encouraging investments in emerging markets.

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[2] *The World Bank Group's Support to Capital Market Development*, main report, the World Bank, 2016, p. vi, available at: https://openknowledge.worldbank.org/bitstream/handle/10986/25268/109331-REPLACEMENT-FILE- PUBLIC.pdf?sequence=1&isAllowed=y

[3] *What are capital markets telling us about the banking sector?* Speech by Jaime Caruana, General Manager, Bank for International Settlements, at the IESE Business School conference on "Challenges for the future of banking: regulation, governance and stability" London, 17 November 2016, available at: https://www.bis.org/speeches/sp161117.pdf

[4] *Opportunities and Constraints of Market-Based Financing for SMEs,* OECD Report to G20 Finance Ministers and Central Bank Governors, OECD, September 2015, available at: https://www.oecd.org/finance/financial-markets/Opportunities-and-Constraints-of-Market-based-Financing-for-SMEs.pdf

[5] *Market-Based Long-Term Financing Solutions for SMEs and Infrastructure*, Research Note, Board of IOSCO, September 2014, p1, available at: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD452.pdf

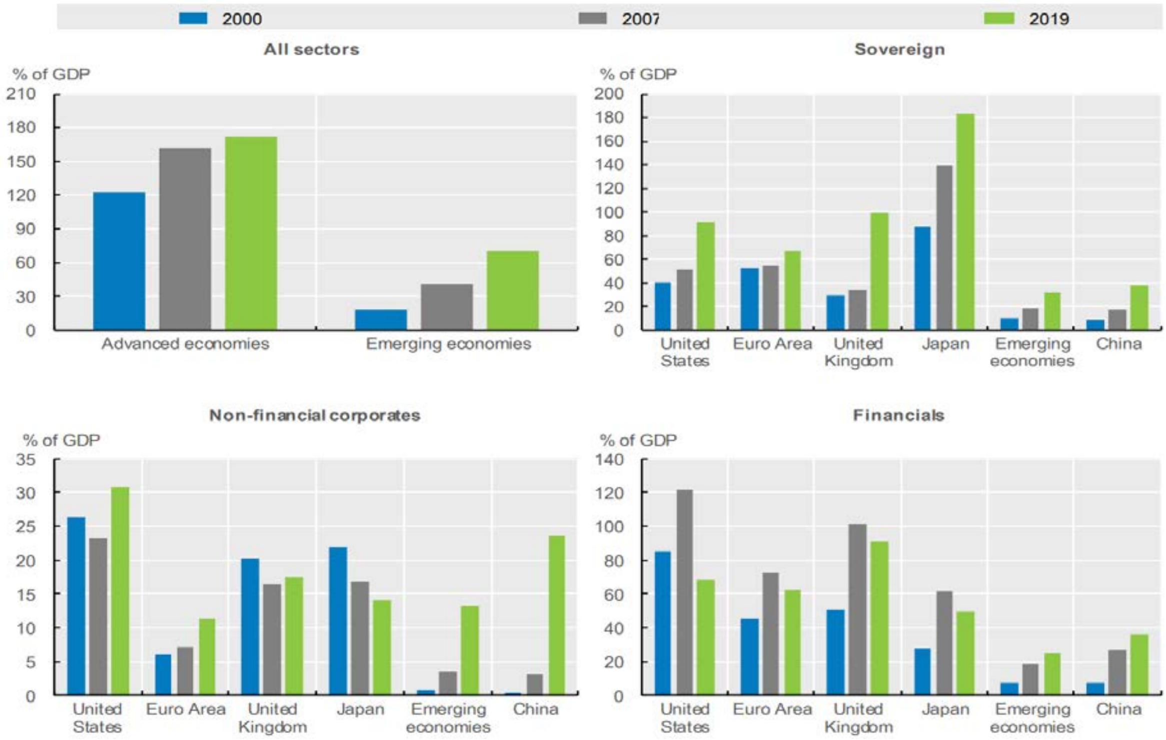
An example can be seen in the following chart, which shows the growth in market capitalisation in EMs between 2000 and 2019, noting the important increase after the GFC (2007/2008) and in 2019.

Chart 1:Market capitalisation in Emerging Markets

Source: World Federation of Exchanges

This shift towards market-based finance has also taken place in the debt sector, once more highlighting the importance of capital markets in market development. In the decade following the GFC, outstanding debt in sovereign, financial institution and non-financial corporate debt markets have grown considerably as indicated in the charts below.

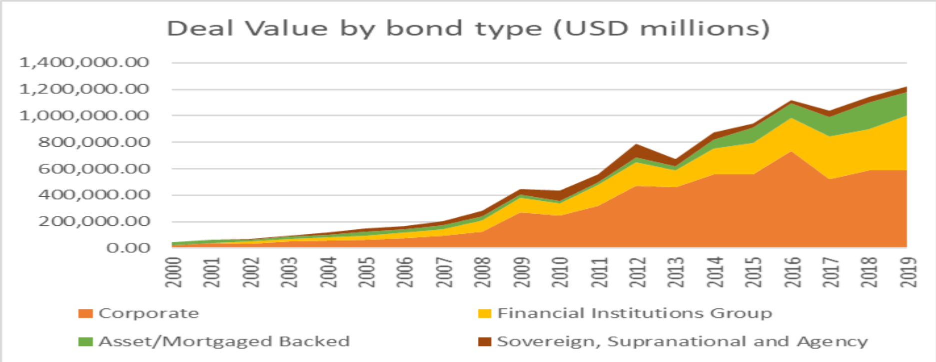
Chart 2: Bond Outstanding to Gross Domestic Product (GDP)



Source: OECD Working Papers on Finance, Insurance and Private Pensions No. 44, 2020[6]

6 *Structural developments in global financial intermediation: The rise of debt and non-bank credit intermediation*, OECD Working Papers on Finance, Insurance and Private Pensions No. 44, 30 March 2020, available at: https://www.oecd-ilibrary.org/docserver/daa87f13-

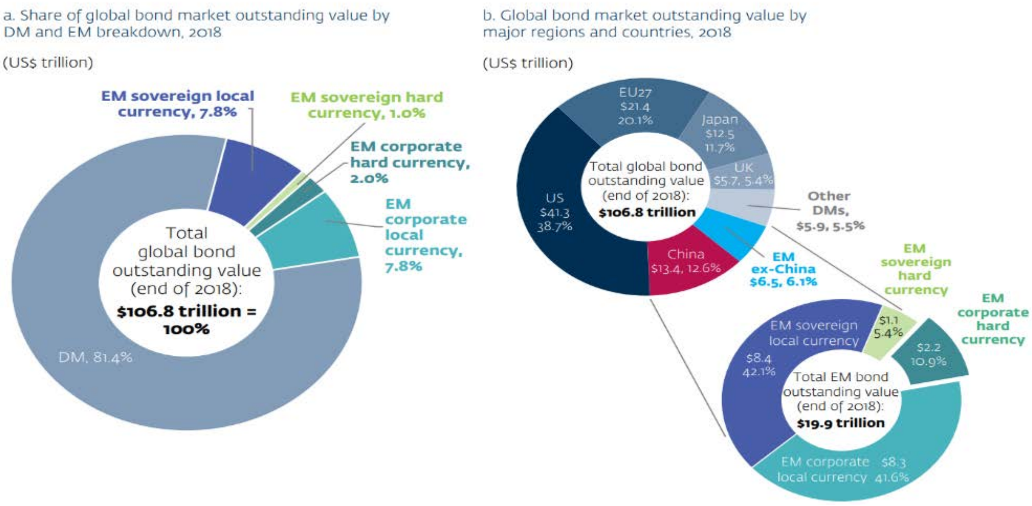
Chart 3: EM bond issuances in domestic market (total): deal value by bond type



Source: Dealogic

Nevertheless, EMs make up only 18.3 percent of the global bond market, with USD 19.9 trillion in outstanding bonds as of 2018. Within that context, China accounts for a total of USD 13.4 trillion outstanding bonds, constituting 67.3 percent of the EMs bond market and 12.6 percent of the global bond market. Within the emerging bond market segment, local-currency bonds remain the primary capital market funding source for both sovereigns and corporates, with USD 8.4 trillion and USD 8.3 trillion in outstanding value, respectively. In contrast, hard-currency bonds have a total of USD 3.3 trillion in outstanding value or 16.3 percent of the total EMs bond market.

Chart 4: Global Bond Markets Size[7]



Note: EU 27 includes the 27 member countries of the European Union, excluding the United Kingdom. DM = developed market; EM = emerging market

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n.pdf?expires=1603191386&id=id&accname=guest&checksum=A4A2084DDDF66638015F58916D52F478

7 *Emerging Markets: Assessment of Hard-Currency Bond Market, An Analysis of Emerging-Market Hard-Currency Bonds Issued by Financial Institutions*, Report, International Finance Corporation, World Bank Group, 05 May 2020, available at: http://documents1.worldbank.org/curated/en/787491596089491233/pdf/Emerging-Markets-Assessment-of-Hard-Currency-Bond-Market-An-Analysis-of-Emerging-Market-Hard-Currency-Bonds-Issued-by-Financial-Institutions.pdf

7 *Emerging Markets: Assessment of Hard-Currency Bond Market, An Analysis of Emerging-Market Hard-Currency Bonds Issued by Financial Institutions*, Report, International Finance Corporation, World Bank Group, 05 May 2020, available at: http://documents1.worldbank.org/curated/en/787491596089491233/pdf/Emerging-Markets-Assessment-of-Hard-Currency-Bond-Market-An-Analysis-of-Emerging-Market-Hard-Currency-Bonds-Issued-by-Financial-Institutions.pdf

Sources: Bank of International Settlements Debt Securities Statistics; JP Morgan CEMBI Monitor, June 2019; IFC analysis

The chart suggests that EMs can do more to attract foreign investors, increase the depth of their capital markets and thereby provide further sources of funding to the local real economy. The next chapter considers the gaps that may still exist in EMs and can deter these investments. This is followed by a chapter that discusses how to address those gaps.

Chapter 3. Gaps in Capital Markets Development

While emerging markets are heterogenous in nature, they share an array of characteristics which may be impeding the development of sound capital markets. For example, emerging capital markets notably face challenges regarding the availability, diversity, and pricing of capital. As compared to developed markets, markets are more volatile and less reliable sources of funds for issuers in EMs, in part because EM issuers lack options to diversify funding and to match funding with their needs. As an example, the absence of a viable bond market reduces the flexibility of corporate borrowers to align funding structures with assets and future earnings. Investors in these markets face a more volatile and higher cost of capital compared with developed markets. This makes it more difficult to raise funds for new projects and to grow or innovate. Ultimately, this restrains economic growth.

This chapter explores the gaps which may have led to these challenges.

- ***Institutional Settings and Regulatory Frameworks***

Many EMs continue to suffer from weak institutional and legal frameworks, low levels of economic development, and high levels of financial and social risk. With regard to regulatory frameworks more specifically, the lack of sound corporate governance at the issuer level can lead to concerns about equitable treatment of shareholders, timely and accurate disclosure of relevant corporate information, professional, qualified and accountable management, as well as adequate identification, measurement and control of risks. Challenges such as abusive related-party transactions, disclosure failures, corruption scandals, and undue political interference in state-owned enterprises – and the lack of effective regulation within this area – all act as a disincentive for investors as noted in the GEMC report on ***Corporate Governance in Emerging Markets***[8] (*GEMC Corporate Governance report*). This is a key gap that requires actions at the regulatory level.

In addition, any concerns about **market oversight** in EMs can also act as a disincentive to invest in those markets. A key goal of such oversight is to ensure fair and orderly trading. To achieve this, regulators use market surveillance to identify rule breaches, erroneous activity (e.g., order entry arising from a malfunctioning algorithm or fat finger error) or other forms of activity that may be deemed inappropriate (e.g., the deliberate submission of excessive numbers of orders and cancellations) or disruptions to orderly trading. Another aim of market surveillance is to detect or uncover market abuse. This includes the ability to detect possible instances or patterns of market abuse and to investigate referrals from market participants and the public. Given these goals, a lack of confidence by investors in domestic market oversight is an essential gap that needs to be addressed to strengthen capital markets in emerging jurisdictions.

- ***Health of markets: Market liquidity and Volatility***

Primary markets are **more volatile** and less reliable sources of funds for issuers in EMs. For example, the absence of a viable bond market reduces the flexibility of corporate borrowers to align their funding structures with assets and future earnings. Investors in these markets face a more volatile and higher cost of capital compared with developed markets. This makes much

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[8] FR10/26 *Report on Corporate Governance*, Final Report, Growth and Emerging Markets Committee of IOSCO, October 2016, available at: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD544.pdf

more challenging to raise funds for new projects and to grow or innovate. Ultimately, this restrains economic growth.

Market liquidity is an essential condition for the market to function effectively for several reasons. First, it has significant impacts on price formation and discovery, which are the building blocks of an efficient market which in turn attracts both issuers and investors. Second, it is also important for financial stability as it helps absorb systemic shocks. For instance, a liquid market is generally able to cushion price volatility brought about by sudden shifts in investor risk appetite. As set out in the GEMC report on ***Factors Influencing Liquidity in Emerging Markets"***[9] (*GEMC Liquidity report*), it is currently difficult to achieve liquid markets in certain EMs. This is due to gaps in market structures, trading infrastructure and regulatory frameworks such as those that lower transaction costs, facilitate trading and timely settlement, and ensure that large trades have only limited impact on market prices.

- ***Investors: Diversification and types of investors***

Diversification in the type of investors in domestic capital markets plays an important role in promoting the health and depth of these markets. In that context, **institutional investors** such as foreign investment funds, have played an increasingly important role in the development of EMs in a search for yield given the low interest rate environment in developed jurisdictions.

Markets with large numbers of institutional investors tend to be less volatile and efficiently allocate resources and capital to companies requiring funding. Institutional investors achieve economies of scale by pooling assets and to employing high quality investment professionals, developing better investment strategies and building sound risk management systems, all of which can result in better returns for investors. Nevertheless, as identified in the GEMC report on the ***Development and Regulation of Institutional Investors in Emerging Markets,***[10] (*GEMC Institutional Investors report*), there are challenges in EMs with regard to attracting institutional investors. These challenges include limited capital market size and liquidity, competition from substitute services, regulatory restrictions and constraints on cross-border activities. A pragmatic and sequenced approach by regulators is required to overcome these challenges, and adequate safeguards are needed at both the market and regulatory levels.

Retail investors can also play an important role in capital markets, particularly in jurisdictions where overall wealth is rising as new middle classes are looking for opportunities to increase their capital and meet their longer-term objectives. Nevertheless, this investor base is not yet fully developed in many jurisdictions which leaves a potential gap in funding sources for the real economy. Where retail investors are concerned, improving their access to investment opportunities highlights another gap relating to investor education. Indeed, investor education is integral to investor protection, a core IOSCO objective. Educated investors generally have better comprehension of financial disclosures and are better able to make informed investment decisions, thus improving their investment outcomes and encouraging them to further invest. As financial innovation continues to evolve, adding complexity and diversity to investment products and services, education becomes even more essential because educated investors are generally better protected from misconduct and financial fraud.

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9 *Factors Influencing Liquidity in Emerging Markets*, Report, Emerging Markets Committee of IOSCO, December 2007, available at: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD258.pdf

10 FR04/12 *Development and Regulation of Institutional Investors in Emerging Markets*, Report, Emerging Markets Committee of IOSCO, June 2012, available at: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD384.pdf

- ***Funding sources: Asset classes***

Corporate Bond Markets. The corporate bond market provides LTF to financial entities and offers benefits for investors with diverse products meeting their risk profiles. Corporate bond markets across EMs are growing, with a large portion of activity concentrated in emerging Asia. This growth is being spurred by broad financial sector development, infrastructure improvement and increasing institutional health. [11]

Nevertheless, as identified in IOSCO's GEMC report on the ***Development of Corporate Bond Markets in the Emerging Markets,***[12] (*GEMC Corporate Bond Markets report)* there remain – in certain jurisdictions – a number of challenges affecting the development of efficient corporate bond markets. The impediments include elements such as:

- *Onerous primary market issuance process:* Primary market issuance of corporate bonds in EMs may be challenging for many corporations, as they may be subject to onerous and time-consuming primary market issuance processes;
- *Absence of Benchmark yield curve*: Without an efficient benchmark yield curve, pricing in the primary and secondary markets of corporate bonds may be constrained. In addition, without a regular or scheduled issuance to create this benchmark yield curve, issuers and investors will not be able to plan their issuances and investments appropriately;
- *Liquidity* concerns: These concerns arise due to investment strategies adopted by corporate bond investors and the size of corporations in emerging markets, which are normally smaller relative to developed markets and issue bonds in smaller sizes;
- *Thinly Traded Instruments:* While EMs have exchange traded markets, trades still continue to be mainly executed on the OTC market. In both cases, however, trade sizes are small and there is little depth to the market;
- *Narrow investor base:* This is due to greater familiarity in investing in equity and government bonds, favourable tax treatment for investments in government bonds and minimum rating requirements or limits on the maximum exposure for investments in corporate bonds;
- *Lack of transparency:* While comprehensive primary and continuous disclosure requirements are in place, these disclosures are not always sufficiently meaningful to allow investors to make informed investment decisions in the corporate bond market; and
- *Limited market oversight:* Some regulators may have limited experience, skills and expertise to regulate the corporate bond market; many regulators tend to focus their attention on the regulation and supervision of the equity market, given the higher level of participation of retail investors.

SME financing. The G20 has acknowledged the need to improve access to financing and the role that capital markets can play in addressing the intermediation gap between the supply and demand for LTF. Nevertheless, SMEs may represent a relatively high investment risk and, in

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11 *Corporate Bond Markets: An Emerging Markets perspective Volume II*, Rohini Tendulkar, Staff Working Paper SWP6/2015, IOSCO Research Department, 25 September 2015, available at: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD510.pdf

12 FR10/11 *Development of Corporate Bond Markets in the Emerging Markets*, Final Report, Emerging Markets Committee of IOSCO in collaboration with the World Bank Group, November 2011, available at: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD360.pdf

many jurisdictions, continue to face impediments that discourage them from raising financing on capital markets. These challenges include fear of losing ownership and relatively high regulatory costs on the part of the SMEs themselves, while their investment proposition may not meet the needs or risk appetite of local investors.

In recognition of the increasing role that the capital markets play in the provision of LTF for SMEs and infrastructure, the IOSCO LTF report reviewed the issues and challenges facing LTF and the opportunities for growth. The report describes innovative structures and products in equity capital markets, debt capital markets, securitisation, and pooled investment vehicles that provide practical solutions to broadly recognised challenges for the financing of SMEs and infrastructure projects. SMEs are a major contributor to long-term economic growth and employment of a jurisdiction. However, they are constrained in their financing due to the relatively high investment risk they represent. The GEMC report on ***"The SME Financing Through Capital Markets"***[13] (*GEMC SME report)* identifies further challenges facing SMEs in accessing market-based financing. The report explores the loss of management control; costs of an initial public offering and listing requirements; and limited interest from investors and analysts, among other issues. Many emerging market jurisdictions are examining their respective regulatory frameworks and taking specific initiatives to facilitate SME access to capital markets.

Derivatives markets. Financial derivatives play an important role in allowing investors to hedge their risks, thereby potentially increasing their appetite towards greater portfolio diversification, including in EMs assets. Indeed, financial derivatives allow investors to unbundle and redistribute various risks — foreign exchange, interest rate, market, and default risks — and thus, facilitate cross-border capital flows.[14]

Nevertheless, the GFC revealed the severity of problems related to the lack of effective and prudent regulation and risk management practices in derivatives markets, and specifically where these markets are Over The Counter (OTC). In that context, gaps in regulation can decrease incentives for market participants to use local derivatives markets as they may have concerns about market abuse and increased counterparty risk for example – issues which have been covered as part of the G20 Reforms. [15]

Although the OTC markets in EMs are not as complex and developed as the OTC markets in developed countries, the GEMC conducted a study to examine the approaches and experience with regulating OTC markets and derivatives trading in EMs. The GEMC report on ***OTC Markets and Derivatives Trading in Emerging Markets***.[16] (*GEMC Derivatives report*) highlighted issues around data availability and transparency in the OTC markets.

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13 FR11/2015 *SME Financing through Capital Markets*, Final Report, FR11/2015, Growth and Emerging Markets Committee of IOSCO, July 2015, available at: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD493.pdf

14 *Chapter IV Selected Topic: The Role of Financial Derivatives In Emerging Markets*, Global Financial Stability Report, December 2002 : Market Developments and Issues, Monetary and Capital Markets Department, International Monetary Fund, December 2002, available at: https://www.elibrary.imf.org/view/IMF082/02829-9781589061927/02829-9781589061927/ch04.xml?language=en&redirect=true

15 *Review of OTC derivatives market reforms, Effectiveness and broader effects of the reforms*, Report, Financial Stability Board, 29 June 2017, available at: https://www.fsb.org/wp-content/uploads/P290617-1.pdf

16 FR07/10, *OTC Markets and Derivatives Trading in Emerging Markets*, Final Report, Growth and Emerging Markets Committee of IOSCO, available at: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD330.pdf

Chapter 4. Addressing the Gaps in Capital Markets Development

Given the analysis in the previous chapter, this section examines how these gaps can be addressed. It draws on IOSCO's objectives, principles, recommendations and various GEMC reports. These range from certain *preconditions* establishing the overall environment within which capital markets should develop to specific recommendations on different segments within the capital market in EMs.

- ***Preconditions for capital market development***

In its 2019 study,[17] the World Bank highlighted the need for a number of preconditions for capital markets to develop. Such preconditions include a stable macroeconomic environment, which effectively means economic growth, low inflation, and robust fiscal policies; a certain level of development of the financial sector, including a robust banking sector, institutional investors, and financial openness; and a robust legal and institutional environment, including mechanisms to ensure the protection of investors and, more generally, that the country abides by the rule of law.

Trust as the main precondition. The integrity of the marketplace and the protection provided to investors are, of paramount importance. Trust and confidence in capital markets are also the main drivers of cross-border retail and institutional flows. These qualities can be achieved by encouraging an efficient and effective supervisory and regulatory framework covering strong investor protection, robust oversight of the market participants, strong surveillance and enforcement of marketplace rules and regulations, and a high level of transparency.

Need for a complete, efficient, and interconnected legal framework. A sound and effective legal framework is important for the integrity, growth, and development of securities markets. IOSCO's Objectives and Principles for Securities Regulation[18] sets out 38 Principles, which are based upon the three objectives of securities regulation, namely i) protecting investors, ii) ensuring that markets are fair, efficient and transparent, and iii) reducing systemic risk. The IOSCO Principles represent the foundation for the securities regulation in any jurisdiction. The Assessment Methodology,[19] developed to assist with the implementation of these principles, states that effective securities regulation depends upon an appropriate legal framework. These Objectives and Principles also point to the need for preconditions in the following areas: Company law; Commercial Code / Contract Law; Taxation Laws; Bankruptcy and Insolvency Laws; Competition Law; Banking Law; and Dispute Resolution System.

Robust regulatory framework and the role of securities regulators. Among other things, the IOSCO Principles establish the desirable attributes of a securities regulator. An independent and accountable regulator with appropriate powers and resources is essential to ensure the achievement of the three core objectives of securities regulation mentioned earlier. The Principles consider the enforcement and market oversight work of the regulator and close cooperation between regulators as essential to the achievement of the regulatory function. The

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17 See *Capital Markets Development: Causes, Effects, and Sequencing,* World Bank, December 2019, supra fn No 1.

18 *Objectives and Principles of Securities Regulation,* IOSCO, May 2017, available at*:* https://www.iosco.org/library/pubdocs/pdf/IOSCOPD561.pdf

19 *Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation*, IOSCO, May 2017, available at: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD562.pdf

potential role of self-regulatory organisations and the desirable attributes of such organisations are also addressed under the IOSCO Principles.

Comprehensive, adaptable, and efficient regulation are also necessary components to fulfil IOSCO's objectives. Regulators have a critical role to play in enforcing laws and regulations that protect investors and ensure that markets operate fairly and efficiently. Equally important is the need to review the regulatory perimeter, particularly in current times. The regulator should be able to regularly review whether its current regulatory requirements and framework adequately addresses risks posed to investor protection, and to fair, efficient, and transparent markets, as well as to the reduction of systemic risks. A regular review of the perimeter of regulation will also consider the effectiveness of existing regulations and the need to modify them or adopt new regulations in light of new market developments. The regulatory framework should at all times ensure that the regulator has sufficient independence for the day-to-day operational activities, powers and resources (both financial and human) to effectively regulate and supervise market participants, products and activities.

Capital markets regulation sets out the core functions of the regulators such as licensing, oversight and enforcement with regard to market participants and products. Regulation of market participants should assist investor protection by setting minimum entry standards and ongoing supervisory requirements. Supervision should include a comprehensive system of inspection, surveillance, and ongoing compliance programs, including regular interaction between the regulator and market participants. Effective supervision and, ultimately, deterrent enforcement actions, also depend upon close cooperation between regulators at the domestic and international levels. Regulators should be able to detect, deter and penalise market manipulation and other unfair trading practices.

- ***Institutional Settings and Regulatory Frameworks***

As noted above, EMs continue to suffer from weak institutional and legal frameworks, notably with regard to corporate governance and market oversight.

Corporate governance. The *GEMC Corporate Governance report* discussed the direction regulators should take to improve the quality of boards, ensure that remuneration and incentive structures work to create long-term value rather than promote excessive risky behaviour, and improve risk management and internal controls. The report identifies possible measures and regulatory approaches aimed at strengthening corporate governance in emerging market jurisdictions and aligning regulatory frameworks with internationally recognised standards in this area. The report also identifies further initiatives and approaches for raising the bar regarding the implementation of best corporate governance practices, including encouraging greater board diversity and quality reporting of sustainability, social responsibility, and cyber risks.

Market Oversight. The GEMC report on ***Approaches to Market Surveillance in Emerging Markets***[20] examines the methods adopted by EMs exchanges and/or regulators in conducting surveillance of markets. This required examining the fundamentals of the surveillance program, and the existing instruments and systems in support of surveillance, including having the appropriate tools, skills and capacity, and coordination and cooperation mechanisms between relevant authorities to enhance the surveillance capabilities.

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[20] *Approaches to Market Surveillance in Emerging Markets*, Final Report, Emerging Markets Committee of IOSCO, December 2009, available at: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD313.pdf

The report also analyses the methods used to intervene once market abuse is detected and the role that international cooperation with foreign exchanges and/or regulators plays regarding to matters involving market surveillance. Further, it provides EMs regulators with a greater understanding of the key regulatory issues and challenges affecting market oversight and identifying critical factors specific to emerging markets that could shape regulatory responses.

In addition to the identified gaps, this section also recognises the importance of **international cooperation and the exchanges of information**.

The **IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information** (MMoU) is the instrument used by securities regulators to help ensure effective global regulation and preserve and strengthen securities markets around the globe. Since its launch in 2002, the MMoU has provided a mechanism through which securities regulators share with each other essential investigative material, such as beneficial ownership information and securities and derivatives transaction records, including bank and brokerage records. It sets out specific requirements for the exchange of information, ensuring that no domestic banking secrecy, blocking laws or regulations prevent the provision of enforcement information among securities regulators. For 18 years, regulators have used the MMoU to help ensure effective global cooperation and strengthen international securities markets. As of June 2020, the IOSCO MMoU had 124 signatories.

Since 2002, securities markets have undergone widespread changes, driven by new technologies and regulation and the growing role of market-based finance, among other developments. These developments led IOSCO to launch in April 2017 an enhanced standard on cross-border enforcement information exchange that builds on the success of the MMoU. The **Enhanced Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information** (EMMoU) offers securities regulators new enforcement powers for responding to the challenges arising from recent developments in global financial markets. By June 2020, 13 ordinary members had signed the EMMoU.[21]

- ***Health of Markets: Market Liquidity and Volatility***

Market Liquidity. As referred to in chapter 3, market liquidity is an essential condition for any market to function effectively as it impacts price formation and discovery, and it helps absorb systemic shocks. The *GEMC Liquidity report* sets out the following important building blocks for deepening market liquidity:

- Reducing the concentration of ownership in public listed companies and hence increasing free float levels – this is to increase the supply of freely tradable shares in the market;
- Liberalising the intermediary sector to allow for foreign participation in the market, increasing competition to domestic players as well as extending the market's reach into the international liquidity pool;
- Increasing market access, going beyond the traditional broker-dealer set up and allowing more Direct Market Access (DMA), which correspondingly accommodates a diversified range of investors as well as different trading strategies.

21 To facilitate the transfer of personal data between European Economic Area financial supervisory authorities and non/EEA supervisory authorities under the new European Data Privacy Regime that went into effect in May 2018, IOSCO and the European Data Protection Board agreed on an Administrative Arrangement (AA), approved in February 2019. All EEA jurisdictions and 221 non-EEA jurisdictions had signed the AA by mid-October 2020.

- Actively seeking ways to reduce transaction costs. This includes the lowering of prevalent commission rates and taxes to encourage more frequent trading of equities;
- Improving the trading infrastructure of exchanges through technological advancement in trading systems;
- Increasing investment products available in the market, particularly those of derivative instruments. The diversity and breadth of products available would provide options to a wide range of investors with different trading strategies, risk appetites, and investment horizons. More importantly, investors will be attracted to markets with a range of products available for hedging their existing risk positions;
- Increasing the supply of issuances. This can be done through dual and cross-listings, as well as via quality companies with good value propositions and underpinned by best practices in supervision and corporate governance. Promoting quality companies will attract both investors and potential issuers to the markets, thereby increasing both the supply and demand of securities. At the same time, allowing dual listings will encourage domestic companies to adopt international best practices (e.g., in disclosures and accounting standards);
- Encouraging higher retail participation to balance the investor profile in the market, especially in markets where retail investors have a high propensity to trade. The heterogeneity of market participants in terms of transaction needs, risk appetites, and investment horizons can enhance market liquidity;
- Reforming the pension fund system as well as developing the Collective Investment Scheme (CIS) segment of a market. This can help to efficiently mobilise large pools of savings in the market; and
- Developing inter-market linkages and restructuring exchanges. This allows exchanges to efficiently tap multiple markets for liquidity. As exchanges become for-profit entities, they are also likely to be competitive in competing for global order flows.

➢ ***Investors: Diversification and types of investors***

Institutional investors. The *GEMC Institutional Investors report* concluded that developing an institutional investor base should be given high priority by emerging markets because of the concurrent growth in capital markets and increasing demand for professional asset management services from such investors.

The report issued a set of recommendations in this respect covering a wide range of areas, including the macroeconomic environment and market efficiency; product offering and financial innovation; distribution channels and investor education; market openness and accessibility; human capital and professional integrity; and the regulatory framework and financial stability.

Retail investors and investor education. Investor education is integral to investor protection, a core IOSCO objective. The GEMC report on ***Investor education in emerging markets***[22] analysed investor education initiatives, their funding sources, the needs of investors in terms of investment strategies, and the corresponding risks involved, among others. The Report indicated that regulators have demonstrated strong interest in investor education. They were willing to devote up to 10-15 percent of their resources to educational initiatives and recognised

22 *Investor Education*, Report, Emerging Markets Committee of IOSCO, October 2020, available at: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD140.pdf

that knowledge and experience from other members could be very useful to them. The report also refers to the need for enhancing financial and investment literacy among EMs local investors and fostering market development and growth.

Starting with 2017, IOSCO through its committee on retail investors has carried out a **World Investor Week Campaign (WIW).**[23] The objectives of the campaign are two-fold: (1) to disseminate key messages that further investor education, investor protection and financial literacy; and (2) to foster learning opportunities for investors. A secondary objective is to strengthen collaboration among IOSCO members on investor education and protection. Since the first edition of the WIW, the activities and media coverage reached more than 100 million people worldwide every year. For example, for the 2019 edition of the WIW, 66 EMs participated in the campaign. GEMC members organised a wide variety of activities in their jurisdictions such as launching publications and other activities, promoting contests and organising workshops, conferences and other events.

- ***Funding Sources: Asset Classes***

Corporate bond markets. The key recommendations of the *GEMC Corporate Bond Markets report* covered the following areas: (i) prioritising the development of corporate bond markets as a strategic national agenda; (ii) improving market efficiency; (iii) enhancing market infrastructure and widening the investor base; (iv) developing a wider range of instruments in the corporate bond market; (v) strengthening investor protection; and (vi) adopting a conducive taxation framework.

SME financing. The *GEMC SME report* recommends eight measures for the development of SMEs in emerging markets that address key areas such as (i) establishing separate equity and fixed income markets with regulatory requirements tailored to SMEs; (ii) establishing market advisors and market-making systems; and (iii) introducing alternative methods of financing such as private equity, venture capital and securitisation.

Derivatives markets. The *GEMC Derivatives report* sets out a list of 15 recommendations to better equip regulators to oversee this sector. These recommendations cover topics such as market entry; investor protection; standardisation; clearing/central counterparty clearing; transparency; data/reporting; collateralisation; risk management and valuation.

- ***Additional Areas for Market Development in EMs***

In addition to the solutions identified above, the GEMC has explored further opportunities for developing emerging capital markets, including sustainable finance and Fintech. A summary of the main findings and recommendations is provided below.

Sustainable finance. During the past several years, market participants, regulators, and policy makers have increasingly focused their attention on issues concerning sustainable finance in its many forms. These issues are particularly relevant for growth and emerging markets that seek to develop their capital markets. Because sustainability issues affect both the financial markets and market participants (albeit in different ways), they pose risks, but also create opportunities.

[23] See event website: http://www.worldinvestorweek.org/

In 2019, the GEMC published a report on ***Sustainable finance in emerging markets and the role of securities regulators.***[24] The report explores the trends and challenges that influence the development of sustainable finance in emerging capital markets. It also provides an overview of the initiatives that regulators, stock exchanges, policy makers, and others key stakeholders in emerging markets have undertaken in this area. The report covers all three dimensions of ESG -- environmental (including climate change), social and governance -- focusing on the risks that may have an impact on the financial system and the need for appropriate transparency and disclosures.

The report identifies the prerequisites for creating an ecosystem that facilitates sustainable finance, such as an appropriate regulatory framework and fit-for-purpose market infrastructure, reporting and disclosure requirements, governance and investor protection guidelines, and mechanisms to address needs and requirements of institutional investors. The report sets forth a set of ten recommendations that emerging market jurisdictions should consider when issuing regulations or guidance regarding sustainable instruments and additional disclosure requirements of ESG-specific risks.

The recommendations cover (i) integration by issuers and regulated entities of ESG-specific issues in their overall risk assessment and governance; (ii) integration by institutional investors of ESG-specific issues into their investment analysis, strategies and overall governance; (iii) ESG-specific disclosures, reporting and data quality; (iv) definition and taxonomy of sustainable instruments; (v) specific requirements regarding sustainable instruments; and (vi) building capacity and expertise for ESG issues.

This GEMC work complements IOSCO's efforts on sustainability such as the report of the IOSCO Sustainable Finance Network published in April 2020,[25] IOSCO's *Statement on Disclosure of ESG Matters by Issuers* that was issued in January 2019,[26] and the recently established Sustainability Task Force.

Fintech. In 2017, IOSCO released a report on ***Financial Technologies,***[27] which describes a variety of innovative business models and emerging technologies that are transforming the financial services industry. The emerging technologies include financing platforms such as Peer-to-Peer (P2P) lending and Equity Crowd-Funding (ECF); retail trading and investment platforms, including robo-advisers and social trading; institutional trading platforms, with a specific focus on innovation in bond trading platforms, Distributed Ledger Technologies (DLTs), including application of the blockchain technology and shared ledgers to the securities markets. The report also describes the key trends that are setting the stage for tech-driven change in the financial services industry, including the greater availability of data, exponential growth in computing power that facilitates the analysis of ever larger data sets, broader access to and the decreasing cost of goods and services, increasing disintermediation and re-intermediation, and demographic and generational changes.

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[24] FR08/2019 *Sustainable finance in emerging markets and the role of securities regulators*, Final Report, Growth and Emerging Markets Committee of IOSCO, June 2019, available at: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD630.pdf

[25] FR04/2020 *Sustainable Finance and the Role of Securities Regulators and IOSCO*, Final Report, Growth and Emerging Markets Committee of IOSCO, April 2020, available at: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD652.pdf

[26] *Statement On Disclosure of ESG Matters by Issuers*, IOSCO, 18 January 2019, available at: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD619.pdf

[27] *Research Report on Financial Technologies (Fintech)*, IOSCO, February 2017, available at: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD554.pdf

Some regulators already have established dedicated Fintech offices, contact points and hubs while others are launching regulatory sandbox frameworks that enable innovators to experiment with Fintech solutions for financial services. While tech firms operate globally, regulation is conducted largely within national or sub-national borders. The local nature of regulation may create challenges regarding cross-border supervision and enforcement, whereas regulatory inconsistency across jurisdictions increases the potential for regulatory arbitrage. The report indicates that the extent of Fintech development across EMs differs significantly from country to country although Asia is an area of significant development. For example, the report states that the amount of Fintech related investment in the Asia-Pacific region more than quadrupled in 2015 from 2014, to USD 4.3 billion. About 45 percent of that amount can be attributed to developments in China and 38 percent to India.

The widespread adoption of mobile and internet technology is in turn being driven by a change in demographics in emerging markets with a more technology savvy and connected generation of middle-income investors. Investors between the ages of 18 to 34 (so-called “millennials”) are more likely to be internet and smartphone users and to participate in social media networks, compared to those aged 35 and older. Within emerging markets, P2P lending and ECF platforms are the fastest growing Fintech areas. The regulatory environment for P2P lending platforms and ECF varies considerably across emerging markets: in some jurisdictions there is no tailored regulatory framework for ECF or P2P lending, and platform operators need to comply with existing rules and regulations, while other jurisdictions have enacted tailored rules and regulations for P2P lending and ECF.

The report demonstrates that online fund distribution platforms are also gaining traction in emerging markets as they offer an easy and convenient access to fund investment. Among other things, there are several emerging markets with cryptocurrency platforms operating within their jurisdictions. Cryptocurrency-based transfers also are increasingly common, especially in emerging markets with weak bank infrastructure or with capital controls. Regulators in many emerging markets are studying the potential applicability of this technology within financial markets and the regulatory implications.

The GEMC is currently conducting additional work on Fintech-related issues, with a focus on the use of innovation facilitators i.e. innovation hubs, regulatory sandboxes and accelerators in emerging markets. The work aims to (i) understand regulatory and supervisory approaches or responses to Fintech developments relating to innovation facilitators in EMs, (ii) discuss issues and challenges for emerging markets pertaining to implementation/execution and monitoring of these facilitators, (iii) analyse the role of the public and private sector and (iv) set forth recommendations, including guidance as to how securities regulators can develop effective innovation facilitators. This will take into account any lessons learnt in various jurisdictions both in developed countries and emerging market jurisdictions, taking proper account of relevant differences.

Chapter 5. Implementation Challenges in Emerging Markets and the Role of Capacity Building

The previous two chapters highlight the gaps in the development of capital markets in EMs, and how they can be addressed through various regulatory initiatives. As mentioned in the last chapter, IOSCO principles and recommendations -- especially those issued by the GEMC -- can assist members in adopting regulatory measures to aid market development. However, many EM jurisdictions may face challenges in implementing these international standards.

This chapter therefore identifies those challenges and the efforts to address them. Capacity building -- including Education and Training of the regulatory staff and Technical Assistance -- can play an important role in addressing these implementation challenges. This chapter also describes these capacity building efforts.

Since 2012, IOSCO has carried out a comprehensive Implementation Monitoring (IM) program to assist jurisdictions in implementing IOSCO Principles and standards (IOSCO standards), by identifying gaps in implementation. IOSCO, through its Assessment Committee, has carried out a suite of thematic reviews and other IM projects, which led to recommendations for jurisdictions on how to address the gaps and shortcomings identified in the implementation of IOSCO standards.

- ***Challenges in implementing international standards***

With an important focus on emerging markets, the Assessment Committee developed the **International Standards Implementation Monitoring (ISIM)** exercise. The first ISIM project focused on IOSCO Principles for Secondary Markets[28] and resulted in a suite of important recommendations for participating jurisdictions.

The secondary markets Principles are intended to promote fair, efficient, and transparent markets. Principles 33 and 34 refer to authorization, oversight, and ongoing supervision requirements, Principle 35 covers transparency requirements, Principle 36 covers detection and deterring market misconduct and Principle 37 deals with managing risks (such as monitoring large exposures, default procedures and short selling).

The main objective of ISIM is to present a global overview of the status of implementation of each of the five principles by the participating member jurisdictions, based on self-assessments. ISIM also aimed to identify gaps in implementation and examples of good practices in implementing these Principles. Forty member jurisdictions from both emerging and advanced markets and with a balanced representation from across all regions participated in the ISIM.

Based on the information reported by the participating jurisdictions, IOSCO found that the implementation of Principles 33-37 is generally high across most of the participating member jurisdictions. The review noted a variety of different approaches to implementation and several trends and examples have been provided in the report. While the status of implementation varies across jurisdictions, **the gaps in implementation have been observed primarily in nascent and emerging market jurisdictions.** The main findings and the gaps identified are summarised below.

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[28] FR04/19 *Standards Implementation Monitoring (ISIM) on Secondary and Other Market Principles*, Report, IOSCO, February 2019, available at: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD623.pdf

- Principle 33 on authorisation and oversight has been largely implemented, with all jurisdictions reported as having the requirement for authorisation of exchanges (mostly by the regulator). Further, the implementation has been high in relation to (a) arrangements for supervision of exchanges; (b) disclosure of order routing procedures and execution rules; and (c) equitable access to market rules and operating procedures. **Gaps in implementation were found in some jurisdictions, mainly relating to lack of adequate trading control mechanisms, no access to books and records of outsourced service providers, lack of sufficient prudential arrangements, no automated pre-trade controls, no criteria for authorisation of exchange, and lack of mechanisms for review of trade matching algorithms.**
- For Principle 34 on ongoing supervision, participating member jurisdictions reported a high level of implementation. All participating member jurisdictions reported having requirements for supervision of exchanges, monitoring of day-to-day trading on exchanges, and regulator's access to all pre-trade and post-trade information. **The main gap reported relates to the inability of four jurisdictions to withdraw the authorisation of the authorised exchanges.**
- Principle 35 on transparency of trading has been largely implemented, with all member jurisdictions having requirements for pre-trade and post-trade transparency relating to trading on authorised exchanges. Derogation from real time transparency is permitted in most jurisdictions, and the regulator has access to information relating to such derogations.
- Overall, participating member jurisdictions reported that Principle 36 on detection of misconduct and deterrence has been largely implemented, with all member jurisdictions having the regulatory framework for prohibiting market manipulation, insider trading etc. **Gaps in implementation have been found relating to the adequacy of enforcement sanctions and cross-market surveillance.**
- Overall, participating member jurisdictions reported that Principle 37 on risk management has been largely implemented. However, **gaps in implementation were mainly related to the monitoring of large exposures, default procedures, reporting of short selling, and reporting of large trader positions in commodity derivatives markets.**

The report also sets out specific recommendations for the participating jurisdictions on each of the five principles under assessment. The Assessment Committee is currently carrying out a second ISIM project on *IOSCO Principles related to the Regulator* and the final report is expected in the first half of 2021. In addition to the gaps identified through IM, IOSCO also conducts targeted surveys of its members, including at the level of the GEMC, to identify the specific needs of jurisdictions, particularly from emerging markets. For example, IOSCO conducts an **annual survey of the capacity building needs** of its members. Furthermore, the GEMC has a discussion on capacity building needs as a standing item on its agenda.

➢ ***Role of capacity building in addressing gaps in implementation***

Based on the identified needs and gaps in implementation, IOSCO has developed a systematic plan to deliver capacity building activities. By strengthening the regulatory and supervisory proficiency of its members, IOSCO aims to ensure their ability to implement international standards and maintain robust securities markets that serve as drivers of sustained economic growth. IOSCO offers a suite of education and training events organised either at the IOSCO headquarters or by various IOSCO bodies such as the GEMC. For example, for over 20 years, IOSCO has organised an **annual Seminar Training Program (STP)** at its headquarters in Madrid. Designed for junior to mid-level staff of the securities regulators, the program typically focuses on topics that reflect the needs of members as identified in training needs analyses, IM reports, and further discussions with members. The last three editions of the STP covered topics such as *Regulation and Supervision of Investment Funds; Role of Investor Education in Protecting Retail Investors*; and *Enforcement and Cross Border Cooperation.*

In 2016, IOSCO joined forces with the Program on International Financial Systems at Harvard Law School to launch the first edition of **the Global Certificate Program for Regulators of Securities Markets**, an executive education program tailored exclusively to the needs and circumstances of securities markets regulators. The initiative is divided into two phases: a two-week session at IOSCO headquarters in Madrid and a second one-week session at Harvard Law School in Cambridge, Massachusetts. Speakers are experienced securities regulators, academics specialised in financial markets, and others with extensive legal or technical knowledge of international financial systems.

In June last year, over 90 participants from 45 different jurisdictions attended Phase I in Madrid, which covered the fundamentals of securities regulation and compliance. Phase II was conducted at the Harvard Law School in Cambridge, Massachusetts in December 2019 and focused on current and future regulatory challenges and emerging issues in capital markets. Harvard academics, securities regulators and leading public policy makers taught the classes. Since the inception of this program four years ago, more than 370 participants from various IOSCO members have enrolled. By the end of 2019, some 175 members had completed the full three-week program – including the required online learning material and modules of the IOSCO Capacity Building Online Toolkit – and earned a certificate of participation.

IOSCO has developed two other important capacity building tools over time; the Technical Assistance (TA) Program, followed by the Online Toolkit for capacity building. **IOSCO's TA Program** is designed to provide technical assistance programs to help emerging markets regulators implement IOSCO Principles and meet the requirements of the IOSCO MMoU. The TA Program is organised in three modules covering: onsite inspection manuals; enforcement manuals, and the MMoU. In addition to the modules, the TA Program offers workshops on the practical application of the onsite inspection and enforcement manuals. The objective is to encourage members to use the manuals in their daily activities to enhance the efficiency and effectiveness of supervision and enforcement in their jurisdictions.

The purpose of the **Online Toolkit** is to assist IOSCO members, including from emerging markets jurisdictions, in their efforts to develop and implement effective regulatory frameworks for securities regulation. The Online Toolkit offers readily available information in one place including IOSCO Reports, members' case studies and practices, various webinars and presentations, academic research, and bibliography links. This information is an extremely valuable tool, particularly for growth and emerging market jurisdictions.

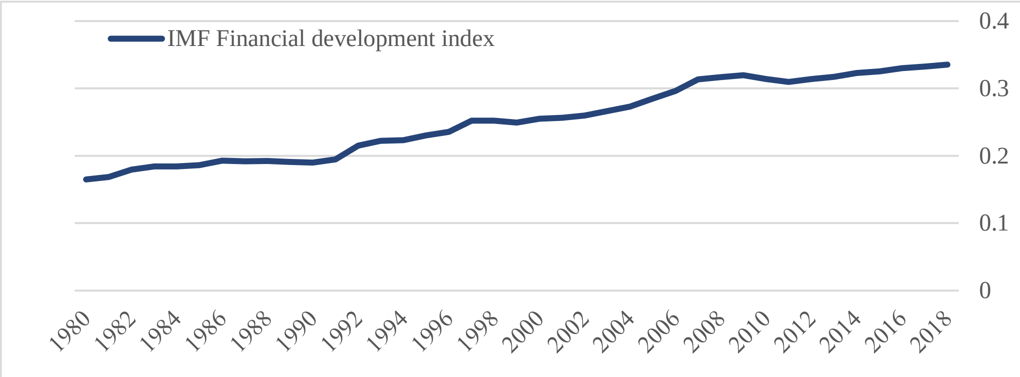
In addition, IOSCO inaugurated its **Capacity Building Hub in Kuala Lumpu**r in March 2017. Hosted by the Securities Commission Malaysia, this initiative allows IOSCO to deliver capacity building activities to securities markets regulators in the region and beyond. The Hub enables IOSCO to leverage on the experience, expertise, and infrastructure of its membership to promote market development and enhance connectivity and inclusiveness in the Asia Pacific region. It also serves to strengthen the regulatory and supervisory capacity of the region´s securities regulators.

Chapter 6. COVID-19 specific challenges for Emerging Economies

➢ ***Overall Developments for EMs***

EMs have been an attractive investment destination for international capital in search of better returns for many years but the low interest rate environment in many developed jurisdictions following the GFC has certainly played an active role in accelerating that trend in recent years. At the same time, many EMs have continued their paths towards liberalisation of their markets, allowing increased participation of global market players. They have also advanced their development, as can be demonstrated by chart 5 below.[29]

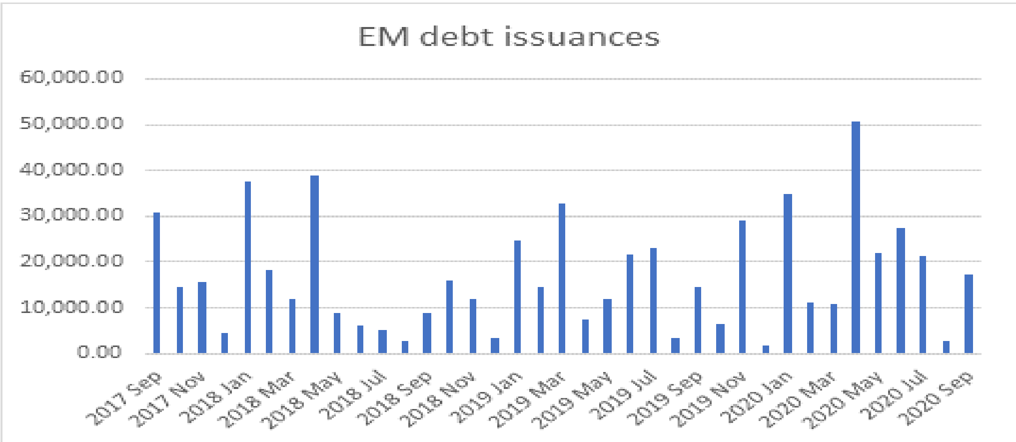
Chart 5: IMF Emerging Markets Financial Development Index



Source: IMF

During the last decade, EMs have benefited from an increasing amount of non-resident inflows in the form of foreign direct investment, portfolio investment (equity, debt securities) and other forms of foreign investment (loans). For example, between 2015 and 2018, 23 percent of international portfolio flows were to EMs, compared with 8 percent in 2007. Nevertheless, reliance on foreign funding can also entail risk for EMs whose markets have been exposed to significant swings – both in terms of inflows and outflows – depending on the vagaries of global financial conditions. As debt levels have increased (see chart 6), so has reliance on foreign funding, leaving EMs more susceptible to these external vulnerabilities.

Chart 6: EM Debt Issuances (USD millions)



Source: Dealogic

As COVID-19 spread around the globe and lockdown measures were imposed, some of these vulnerabilities crystalised.

[29] The IMF Emerging Markets Financial Development Index is a relative rank index based on market depth, access and efficiency of financial institutions and markets.

Massive outflows

When considering flows to EMs, the *push vs pull* framework has often been used to discuss external and domestic factors driving capital flows. The *push vs pull* framework *distinguishes between external and domestic factors driving capital flows to emerging market and provides an intuitive classification of capital flow drivers. (Koepke, 2015).* Some of these factors will act as a positive driver of flows to EMs while others, such as risk aversion, will act as a negative driver of flows.

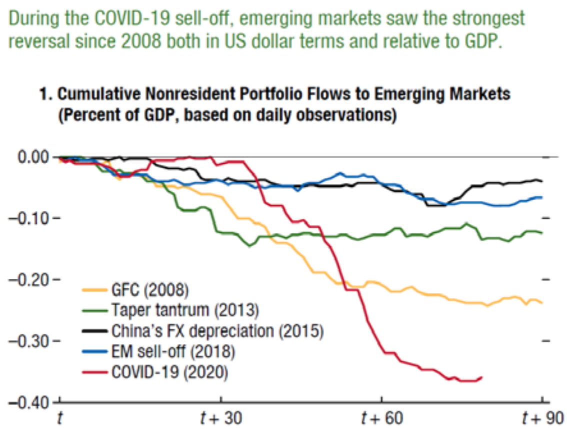
Within this framework, some of the drivers will be structural in nature while others will be more cyclical. Structural drivers are those that have a long-term impact on drivers of flows because they relate to the underlying structure of the economy of an EM. These factors include, but are not limited to, the role of government in the economy and the level of liberalisation of said economy, the quality of the market structures and institutions more generally and the level of institutional investor participation. The other types of drivers are cyclical, meaning they will usually vary across the business cycle. Examples of such drivers include global risk aversion, interest rate levels in developed markets as well as GDP growth, asset return indicators and country risk indicators.

The COVID-19-related macro-economic impacts outlined in the previous sections led to a tightening of financial conditions (see chart 7) and clearly acted as a cyclical *push shock*. According to the IMF, and as demonstrated by chart 8, "*emerging markets have experienced the sharpest portfolio flow reversal on record—about $100 billion or 0.4 percent of their GDP—posing stark challenges to more vulnerable countries.*"[30]

Chart 7: Global Financial Conditions Index[31]

Sources: Goldman Sachs, as referred by Banxico[32]

Chart 8: Portfolio Flows to Emerging Markets



Source: IMF[33]

30 *COVID-19 Crisis Poses Threat to Financial Stability*, Tobias Adrian and Fabio Natalucci, IMF Blog, 14 April 2020, available at: https://blogs.imf.org/2020/04/14/covid-19-crisis-poses-threat-to-financial-stability/

31 The index is defined as a weighted average of risk-free interest rates, exchange rates, stock valuations, and credit spreads. With the weights corresponding to the direct impact of each variable on GDP. It is prepared with information from 19 advanced economies and 18 emerging economies.

32 *Quarterly Report April-June 2020*, Banco de Mexico, 26 August 2020, available at: https://www.banxico.org.mx/publications-and-press/quarterly-reports/%7BCAF19D50-0398-EF9D-AE86-C1764561387C%7D.pdf

33 *Markets in time of COVID-19*, Global Financial Stability Report, IMF, April 2020, available at: https://www.imf.org/~/media/Files/Publications/GFSR/2020/April/English/text.ashx?la=en

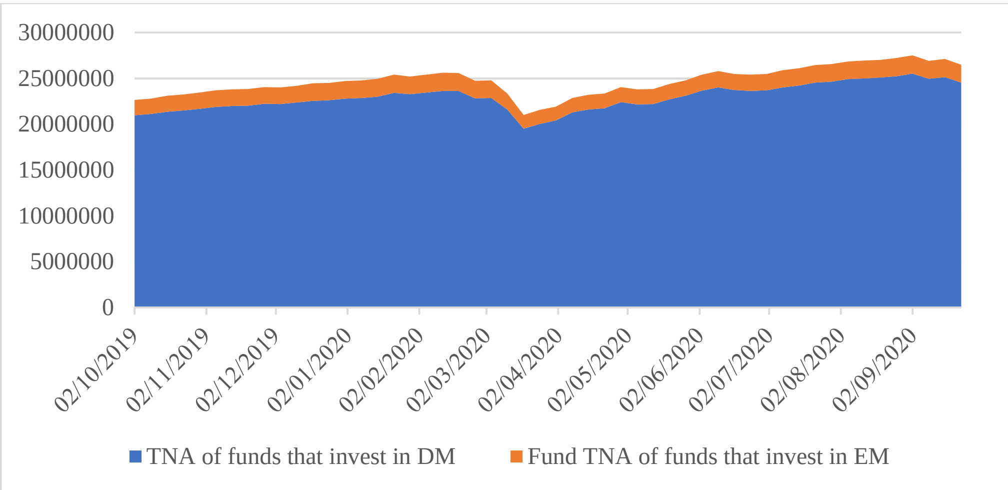
Overall, markets analysts[34] estimate that EMs experienced outflows from foreign investors by around USD 103 billion between mid-January and mid-May 2020 (with the largest outflow in March: USD 83.3 billion).[35] Some estimations indicate that in USD terms, EMs debt suffered losses of between 13.4 percent for hard currency and 15.2 percent for local currency in the first quarter of 2020,[36] although the bond market of some EMs (such as Brazil and Mexico), have been able to better resist the changing financial environment, due in part to the fact that they have a more developed local currency bond market with a larger local investor base. Some of these EMs (e.g., Brazil, Korea, Mexico) also arranged for USD liquidity arrangements (Central Bank Swap Arrangements), which has proved to be extremely useful under the volatile market environment deriving from the COVID-19 situation.[37]

➢ ***Initial Analysis of EM Funds***

The *flight-to-safety* discussed above has also impacted the performance of EM-based investment funds. The Assets under Management (AuM) of investment funds invested in emerging market asset classes remains low relative to the size of the global funds industry, which focuses on allocating assets in developed markets.

The AuM for EM Funds represents a tenth of global allocations (see chart 9). Nevertheless, the AuM of EM funds has been affected marginally more than the AuM of DM funds, declining roughly by 25 percent, compared to a 20 percent drop in DM asset allocations (see chart 10).

Chart 9: Total Net Assets (TNA) of
all Developed Market (DM) funds and all EMs funds (USD millions)



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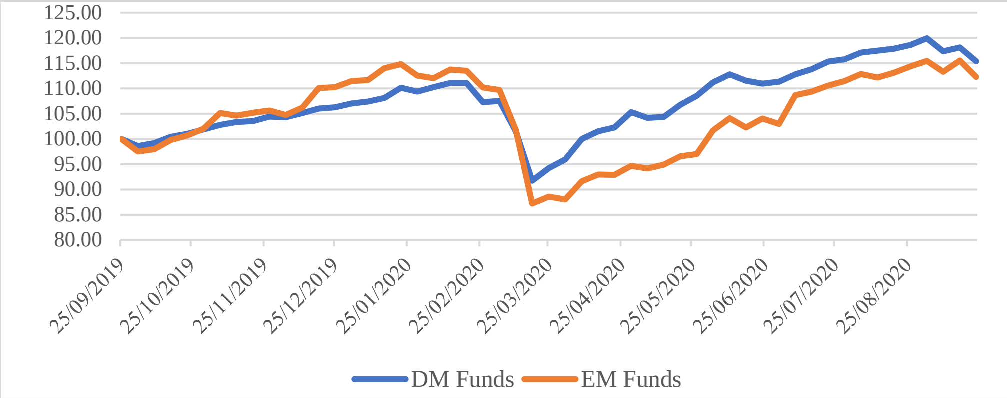
34 *COVID-19 and Emerging Markets: Taking Stock, Moving Forward Commentary*, State Street Global Advisors, 08 April 2020, "*Non-resident portfolio outflows in March 2020 amounted to $31 billion for emerging market debt and $50bn for emerging market equities.*" available at: https://www.ssga.com/library-content/pdfs/ic/covid-19-and-emerging-markets.pdf

35 The Institute of International Finance (IIF) https://www.iif.com/

36 See *COVID-19 and Emerging Markets: Taking Stock, Moving Forward Commentary*, State Street Global Advisors, 08 April 2020, Op. cit. p 3, available at: https://www.ssga.com/library-content/pdfs/ic/covid-19-and-emerging-markets.pdf

37 For instance, on March 19, 2020, the Federal Reserve Bank of New York (FRBNY) entered into temporary U.S. dollar liquidity arrangements (swap lines) with the Banco Central do Brasil, the Bank of Korea and the Banco de Mexico, in amounts up to USD$60 billion each. See FRBNY "Central Bank Swap Arrangements" available at: https://www.newyorkfed.org/markets/international-market-operations/central-bank-swap-arrangements

Chart 10: Evolution of Total Net Assets in Investments funds indexed to 1st October 2019 (YTD October 2020)



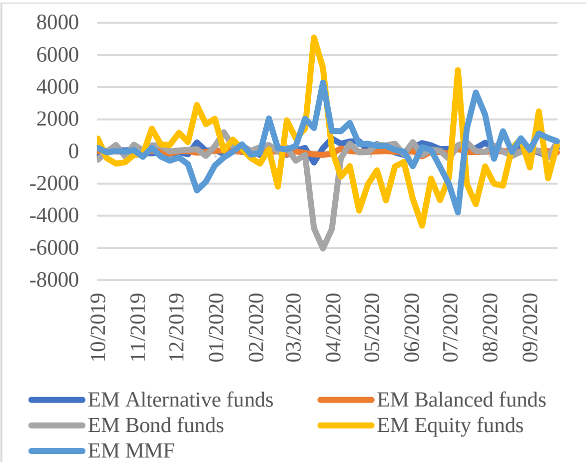
Source: EPFR

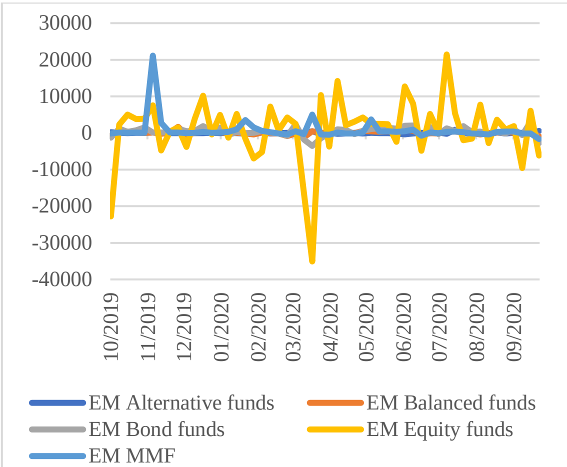
To better understand the potential vulnerabilities at play, it is worth considering the differences between EMs funds denominated in local currencies and EMs funds denominated in hard currency. Foreign investors hold positions in local currency and in hard currency (e.g., USD or the Euro).

However, while foreign investors have increased their presence in local currency bond markets in recent years, they remain predominantly exposed to emerging markets through dollar-denominated assets. Consequently, a brief comparison between hard currency-denominated funds and local currency denominated funds may provide an initial understanding at a high level of the behaviors of domestic investors versus foreign investors within these funds by proxy.

Starting with funds denominated in local currencies, chart 11 shows a decline in allocation to EM bond funds at the height of the pandemic.[38] However, graph 10 also shows a rise in allocation to EM equity funds at the same time, suggesting local investors may have divested from bond funds denominated in local currencies in order to benefit from the fall in valuations in stock markets, as can be seen in the graph on the right.

Chart 11: Flows into EMs Investment Funds, by investment strategy – Weekly flows (left) and Valuation changes (right) (USD millions)





Source: EPFR

38 It is worth noting that for these foreign investors exposed to local currency denominated EM bond funds, the rise in demand for US dollars that accelerated a depreciation of most currencies may have affected their returns and therefore further influenced them into divesting.

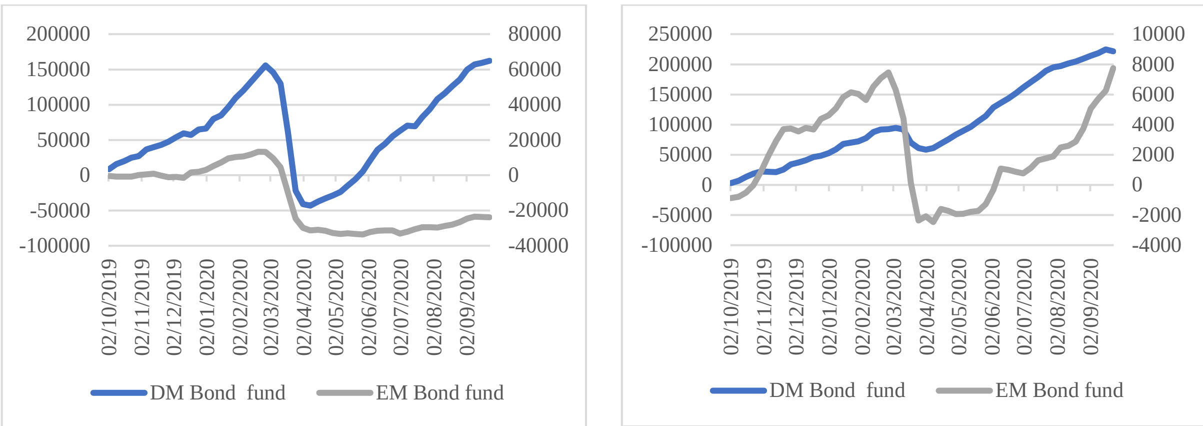
As markets stabilised globally, it was interesting to note outflows from local currency denominated equity funds, while local currency denominated money market funds saw an uptick in inflows. This could suggest local investors sought to benefit from the post-turmoil rise in stock prices before exiting the market in favor of short-term debt.

Overall, these developments may suggest that local investors in EMs funds have a tendency to remain invested within EMs asset classes albeit they will react to market conditions. At the same time, a recent International Monetary Fund (IMF) study[39] shows that portfolio outflows from local currency bond markets were correlated with the weight of the country in the GBI-EM[40] benchmark index, suggesting that benchmark-driven investors may have played a significant role in driving the reversal of portfolio flows.

On the other hand, both EMs bond and equity funds denominated in hard currencies saw outflows, suggesting a *flight-to-safety* behavior by foreign investors as in direct markets themselves. These trends reversed as the turmoil subsided, with global investors returning to EMs bond funds notably. In addition, data on funds based on active versus passive strategies shows that active EMs bond funds in particular are still suffering the consequences of the COVID-19 turmoil. Indeed, while active DM bond funds appear to have recovered from the turmoil, data in chart 12 appears to show a shift towards passive EM bond funds by investors seeking to regain exposure to EMs bond markets.

This may be explained by investors perceiving passive, exchange traded funds, EMs funds to be more liquid than traditional investment funds, thereby allowing them to move in and out more easily should they need to do so in the future. This may give some insight into how investors are perceiving potential risks within emerging markets.

Chart 12: Cumulative flows
Active bond funds (left) and Passive bond funds (right) (USD millions)



Source: EPFR
Note: DM left axis; EM right axis

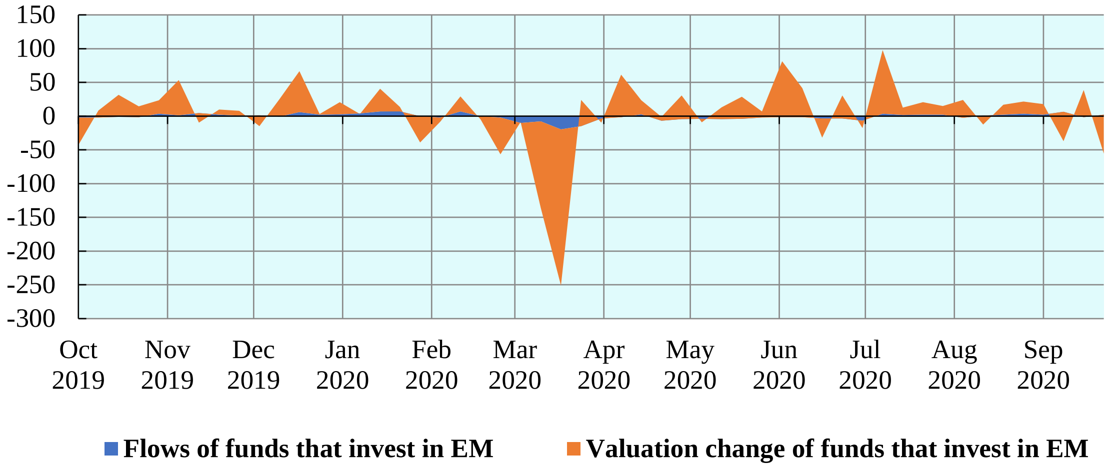
By June, the situation had begun to stabilise, with a return of capital driven by investor appetite for Chinese equities and EM bonds, as is also demonstrated by the uptick in flows to hard

39 *Benchmark-Driven Investments in Emerging Market Bond Markets: Taking Stock*, Serkan Arslanalp, Dimitris Drakopoulos, Rohit Goel & Robin Koepke, IMF Working Paper, 25 September 2020, Available at: https://www.imf.org/en/Publications/WP/Issues/2020/09/25/Benchmark-Driven-Investments-in-Emerging-Market-Bond-Markets-Taking-Stock-49740

40 J.P. Morgan Government Bond Index–Emerging Markets (GBI-EM; for local currency bonds)

currency EMs bond funds as above.[41] The recovery saw an improvement in both institutional and retail flows, but likely remains uneven as many countries are still experiencing capital outflows. With regards to EMs investment funds specifically, it appears the recovery may be more reflective of an uptick in valuations rather than of a surge in new inflows, as can be seen in chart 13.

Chart 13: Decomposition of AuM changes into valuation and flow effects DM and EM



Source: EPFR

Currency depreciation versus USD

The rise in demand for USD to cover collateral positions and cover transactional positions as the COVID-19 unfolded, accelerated a depreciation of most currencies versus USD. Driven by the global liquidity crunch (dash for cash) and increased risk aversion (flight to safety), EMs have been experiencing capital outflows at unprecedented levels.

As the global extent of the COVID-19 outbreak became apparent, the USD valuation benefited from a flight to quality. The rise in demand for USD, driven in part by transactional needs and variation margin calls, was further exacerbated by the reversal of dollar-funded carry trades.

As a consequence, most of the EMs exchange rates experienced significant downward adjustments (chart 14). An analysis by the Organisation for Economic Cooperation and Development (OECD)[42] shows that the currency depreciation accelerated between end-February and mid/end-March 2020, as it can be noted in the graph below. Increased demand for USD generated a depreciation of most currencies amongst EMs.

Since April 2020, those currencies which experienced the biggest drop have however started to recover. This is the case, for example, of the Indonesian rupiah (IDR), and the Russian ruble (RUB), while the South African rand (ZAR) and the Mexican peso (MXN) have stabilised.

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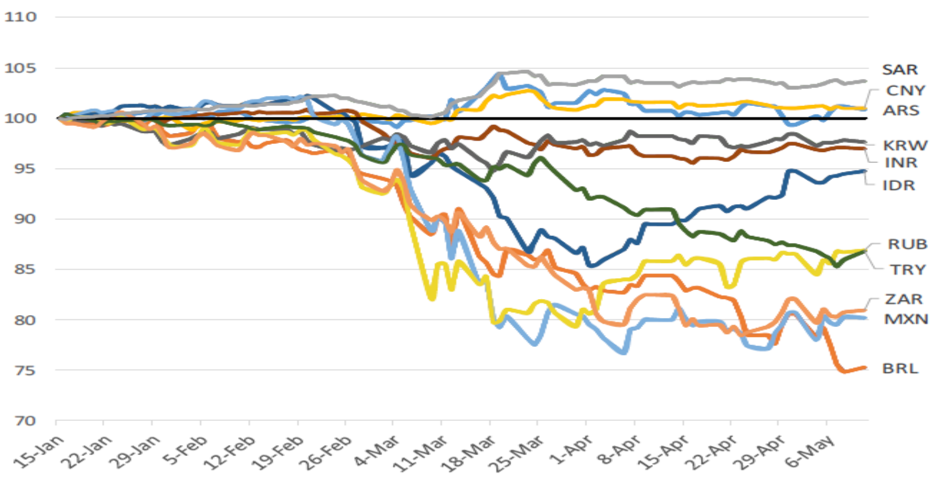
41 *EM Capital Flows Monitor*, IMF, 29 July 2020, available at: https://www.imfconnect.org/content/dam/imf/News%20and%20Generic%20Content/GMM/Special%20Features/July2020EMCapitalFlowsMonitorMCM.pdf

42 *COVID-19 and global capital flows*, OECD Policy Responses to Coronavirus (COVID-19), 03 July 2020, available at: http://www.oecd.org/coronavirus/policy-responses/covid-19-and-global-capital-flows-2dc69002/

Chart 14: Exchange rates – Selected emerging market economies, Jan-May 2020[43]

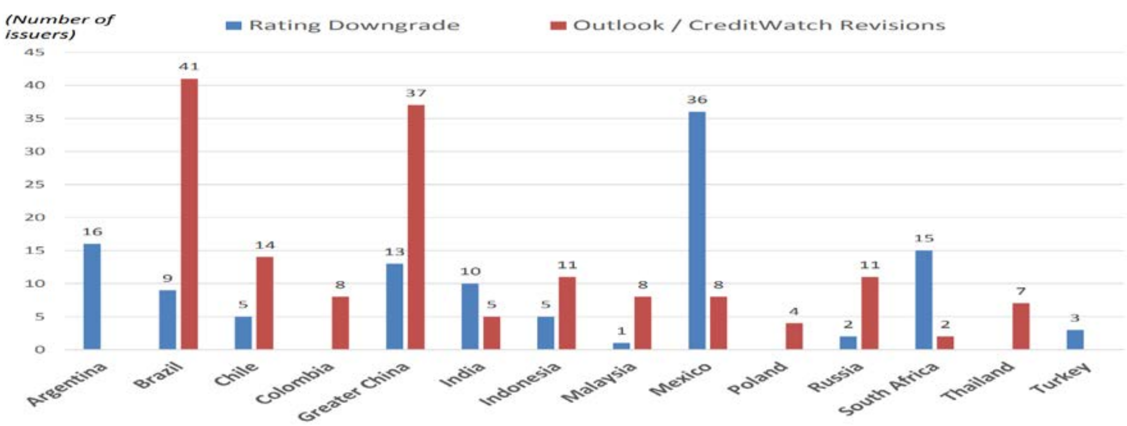


Source: OECD, "COVID-19 and Global Capital Flows", June 2020[44]

Rating downgrades

The dimming economic outlook, falling demand for commodities and the overall deteriorating macroeconomic situation have exerted pressure on many EMs. Moreover, these jurisdictions often have limited monetary and fiscal tools to address the impact on markets of the financial and economic stress caused by the COVID-19 outbreak. They may also find the scope for action restricted by central bank and government measures in developed jurisdictions. As a result, many EMs have seen their credit ratings downgraded, reflecting sovereign and corporate default expectations.[45] Chart 15 below shows the S&P credit rating downgrades and credit watch revisions, from 3 February to 28 July 2020. It gives a sense of the challenges EMs face as the COVID-19 situation continues to unfold unevenly across regions.

Chart 15: Emerging Markets| COVID-19 / Oil-Related Rating Actions



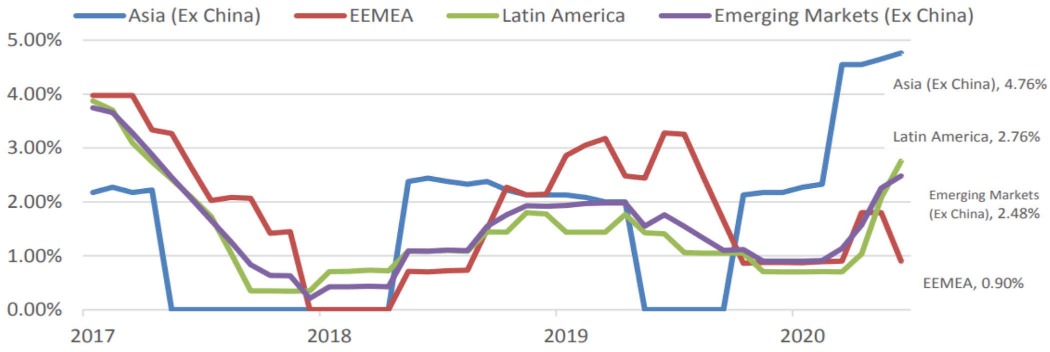
Note: Data includes sovereigns. Data from Feb. 3, 2020 to July 28, 2020.

43 Note: Nominal effective exchange rate (broad index), rebased at 15 Jan 2020=100. An increase indicates an appreciation of the economy's currency against a broad basket of currencies.

44 *COVID-19 and Global Capital Flows*, OECD Report to G20 International Financial Architecture Working Group, June 2020, available at: http://www.oecd.org/investment/COVID19-and-global-capital-flows-OECD-Report-G20.pdf

45 For example, "Of the almost 1,800 rating cuts or downgrade warnings S&P Global has made since the virus exploded, 420 have been in emerging markets, nearly half of all the EM issuers the ratings agency monitors." See Reuters *Emerging market corporate credit quality down but not out*, 8 June 2020 https://www.reuters.com/article/us-health-coronavirus-emerging-corpbonds-idUSKBN23F0P0

Default Rates Begin To Rise Across EMs



Data as of July 29, 2020. OLCW as of July 29, 2020. CreditPro data as of June 30, 2020.

Source: S&P Global Ratings, "COVID-19 Persists, Increasing Downside Risks", 5 August 2020[46]

Credit ratings and, in particular, sovereign credit ratings are nevertheless an important source of information for foreign investors seeking to assess the level of riskiness of emerging market assets (Reinhart, 2002).[47] The resulting impact of COVID-19 on credit ratings for EMs will therefore likely to have further encouraged outflows from EMs asset classes by foreign investors; although it is worth noting research that suggests credit ratings affect the decisions of local investors.[48]

➢ *Initial Analysis of Operational Resilience in EMs*

Notwithstanding the financial and economic challenges that EMs face during the COVID-19 outbreak, capital markets in EMs continue to operate in these difficult circumstances and provide support to the real economy. Securities regulators worldwide face a new situation where financial institutions, financial markets and market participants now provide a significant amount of their services online and a considerable number of their staff work remotely.

EMs have fewer resources and tools to deal with these circumstances than do developed markets. However, EMs regulators have put in place different measures to support operational resilience and keep markets operating during the pandemic. Some of these measures include:

- **Business continuity plans (for firms and regulators)**: issuing guidance specific to business continuity in the current situation; introducing guidance on cyber security and regulatory relief on voice recording requirements; allowing remote working for most/all employees and split team operation.
- **Inspections and oversight:** Changing inspection mechanisms to ensure regulators are able to continue overseeing markets despite the challenging circumstances. This includes

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46 *COVID-19 Persists, Increasing Downside Risks*, Emerging Markets Monthly Highlights, S&P Global Ratings, 05 August 2020, available at: https://www.spglobal.com/_assets/documents/ratings/research/2020-08-05-emerging-markets-monthly-highlights-covid-19-persists-increasing-downside-risks.pdf

47 *Default, Currency Crises, and Sovereign Credit Ratings*, Reinhart, C. M. (2002), World Bank Economic Review, 16(2), 151–170.

48 *Equity Investment by Global Funds: Return and Sovereign Risk*, Andreou, Christoforos and Lambertides, Neophytos and Savvides, Andreas, Cyprus University of Technology, March 2018, available at: https://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID3243269_code938727.pdf?abstractid=3243269&mirid=1

communicating more with industry in key risk areas; extending the deadline to file regulatory documents; and allowing auditors to suspend/delay their on-site visits.

- **Volatility Control Mechanisms:** Activating circuit breakers; making changes to circuit breaker rules; tightening the thresholds for triggering VCMs; lengthening the time of trading halts; strengthening the monitoring of fraudulent activities (including market manipulation); and (temporary) banning or limiting short selling.

Business continuity plans

Both regulators and market participants have implemented Business Continuity Plans (BCPs). For example, market participants have activated their BCPs to ensure the operational continuity of their services. They have also taken measures to assess and secure operational readiness to ensure continuity of their business obligations despite the reduced staff numbers due to COVID-19. Specific plans or actions have been implemented according to the situation in each EM. For example, in addition to allowing wither full or partial remote working for staff or split team operations, EMs regulators have developed guidelines and procedures to address novel aspects of the COVID-19 outbreak and engage more frequently with market participants to identify and assess vulnerabilities.

Measures related to shareholders' Annual General Meetings

EMs have introduced some level of regulatory flexibility to shareholders' meetings. The main objectives of these measures are to promote investor and market confidence by facilitating online participation of investors in shareholders meetings; to facilitate remote Annual General Meetings (AGMs); and ensure business continuity. The regulatory tools encourage the use of technology/digital measures, and proxy voting; introducing flexibility for limiting the number of participants; and facilitating postponement of AGMs by extending the applicable deadline.

Inspections and oversight

EMs have also implemented different tools or means to conduct inspections and oversight activities. This includes, for instance, reviewing information via virtual means; conducting monitoring and surveillance under a specific risk approach; communicating more frequently with industry in key risk areas; and re-prioritising inspection. Some EMs have strengthened their supervisory and market monitoring by engaging more frequently with market participants to identify and assess vulnerabilities and assess operational readiness to ensure continuity of business. In addition, EMs have introduced conditional and temporary regulatory or supervisory relief, such as allowing auditors to suspend/delay their on-site visits; extending the deadline to file regulatory documents and other statutory obligations; and allowing intermediaries to use alternative tools for order recording.

Cyber security

Since the COVID-19 outbreak, use of remote working has reached unprecedented levels, while online services, business operations, and reliance on third parties providers have also increased. While authorities and market participants may be more familiar with traditional operational risk, the novel challenges of the pandemic have increased the cybersecurity risks for authorities, market participants and investors. To address this challenge, EMs have put in place various measures.

Volatility Control Mechanisms

EMs have activated, introduced or modified some VCMs, such as short selling, circuit breakers or listing requirements. Several EMs jurisdictions have banned or limited short selling or have revised the related regulation to enhance market stability. Many have introduced circuit breakers to control volatility in their markets. Other EMs have revised their regulations to address the market volatility. Some EMs have taken measures to ensure the orderly functioning of their markets.

Temporary suspension of trading venues

During COVID-19, capital markets have been a critical segment of the financial markets supporting the real economy. IOSCO issued a public statement indicating that *"The IOSCO Board is committed to ensuring that capital markets continue to function throughout this difficult period in an open and orderly manner to enable all participants to price and transfer risk across all traded asset classes. […]"*[49]

Notwithstanding the above, the GEMC identified three markets that have seen a temporary suspension of their trading venues during the first half of 2020.

- *Bangladesh*: The trading and settlement activities on the Dhaka Stock Exchange and the Chittagong Stock Exchange were suspended from 26 March to 2 April 2020. subsequent closures lasted until 30 May 2020.
- *Jordan*: According to the Jordan Securities Commission Board's decision, trading in the stock market was suspended from 17 March 2020 to 09 May 2020, in line with the Defense Orders No.2 and 3, approved by the Prime Minister on 17 March. These orders requested the closure of all ministries and official/public authorities; and the suspension of private sector activities (including banks and capital market institutions), except for health services.
- *Philippines*: Since 16 March 2020, the Philippine Stock Exchange (PSE) has been operating under shortened trading hours and was closed for two days (17 and 18 March). The Philippine Dealing and Exchange Corp (PDEx) was also closed on 17 March 2020. Securities exchanges have been included in the list of essential services, and the PSE and PDEx resumed their operations on 19 and 18 March 2020, respectively.

IOSCO and the GEMC will continue facilitating the exchange of information and experiences under COVID-19, to assist member jurisdictions to maintain fair, efficient and transparent markets. They will also seek to address systemic risks and enhance investor protection.

➢ ***IOSCO measures during COVID-19***

Though the shock originated outside the financial sector, it created significant stress in the financial markets and financial institutions. Resorting to lockdowns around the globe to address the health crisis hurt economic activity, giving rise to solvency and liquidity concerns. The role of the public sector and banks was and continues to be important in supporting the real economy. Governments and central banks worldwide have played a key role in mitigating the severity of the impact on the real economy.

[49] MR/06/2020 *Securities regulators coordinate responses to COVID-19*, Media Release, 25 March 2020, available at: https://www.iosco.org/news/pdf/IOSCONEWS559.pdf

IOSCO has emphasised the importance of keeping markets open due to the role they play in financing the economy and facilitating the hedging of risks. IOSCO highlighted in its 25 March statement[50] that the continued functioning of equity, credit and funding markets supports the efforts of the real economy in dealing with the crisis by providing access to funding and facilitating the ability to hedge risks. IOSCO therefore expressed its clear commitment to ensure that capital markets continue to function in an open and orderly manner to enable all participants to price and transfer risk across all traded asset classes.

To help address the challenges of the pandemic and to relieve untoward pressure on members, IOSCO decided to reprioritise its work program for 2020.[51] For example, working together with the Basel Committee, IOSCO announced deferral of the final implementation phases of the margin requirements for non-centrally cleared derivatives[52] to provide additional operational capacity for firms to respond to the immediate impact of the pandemic. IOSCO also issued a statement on the application of accounting standards[53] and emphasised the importance of disclosure by issuers of timely and high-quality information[54] about the impact of the pandemic.

During this period, IOSCO members, including those from emerging markets, have exchanged information through an IOSCO information repository about the measures they adopt to address the stresses. Rather than member regulators *re-inventing the wheel*; they have learned from the experiences of others. IOSCO members focus on the operational and financial resilience of market infrastructures, the operational capability of market users and the continued flow of information to these markets. They also provide the appropriate regulatory flexibility to enable market participants to address the challenges posed by the pandemic while ensuring that market integrity and investor protection objectives are maintained.

The pandemic also highlighted the importance of globally coordinated regulatory reforms across sectors. The banking sector was able to absorb the pandemic shock thanks to the global reforms introduced after the GFC. A range of measures agreed by IOSCO regarding liquidity risk management in the asset management sector, volatility control mechanisms in secondary markets, business continuity planning and cyber resilience, as well as joint work with Committee on Payments and Market Infrastructures on Financial Market Infrastructure resilience and with the Basel Committee on Banking Supervision on margin requirements for non-centrally cleared derivatives, helped to address market vulnerabilities. Indeed, the shift to central clearing has likely helped reduce systemic risks during the peak of the turmoil. Working together during the crisis also helped regulators pursue the fundamental objectives of why they regulate markets -- investor protection, market integrity and systemic risk -- which are IOSCO's core objectives.

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50 MR/06/2020, *Securities regulators coordinate responses to COVID-19 through IOSCO*, Media Release, IOSCO, 25 March 2020, available at: https://www.iosco.org/news/pdf/IOSCONEWS559.pdf

51 MR/09/2020, *IOSCO reprioritizes its work program to address impact of COVID-19*, Media Release, IOSCO, 08 April 2020, available at: https://www.iosco.org/news/pdf/IOSCONEWS562.pdf

52 MR/07/2020, *Basel Committee and IOSCO announce deferral of final implementation phases of the margin requirements for noncentrally cleared derivatives*, Press Release, Basel & IOSCO, 03 April 2020, available at: https://www.iosco.org/news/pdf/IOSCONEWS560.pdf

53 MR/08/2020, *IOSCO Statement on Application of Accounting Standards during the COVID-19 Outbreak*, Media Release, IOSCO, 03 April 2020, available at: https://www.iosco.org/news/pdf/IOSCONEWS561.pdf

54 OR/02/2020, *IOSCO Statement on Importance of Disclosure about COVID-19*, Media Release, IOSCO, 29 May 2020, available at: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD655.pdf

IOSCO has also reiterated that the principles of full, timely and fair disclosure of current and reliable information material to investment decisions are of extreme importance during the current situation.[55] Therefore, it is important that issuers consider all aspects of their business when preparing financial reports. Clearly written financial statements and management commentary is important to investors' information needs and confidence. Issuers should explain (i) how COVID-19 impacted and/or is expected to impact the financial performance, financial position and cash flows of the issuer, (ii) how the strategy and targets of the issuers have been modified to address the effects of COVID-19 and (iii) measures taken to address and mitigate the impacts of the pandemic on the issuer.

➢ ***Next steps***

The GEMC is currently examining how the COVID-19 pandemic has impacted emerging markets and is looking into possible solutions for the recovery phase. The GEMC will further analyse how solutions such as strengthening sustainable finance, blended finance and Fintech, among others, will assist in the recovery phase of EMs.

As the world looks to recover from the disruption of COVID-19, policymakers and others are aiming at "*creating a recovery that is sustainable, inclusive and delivers concrete reforms.*"[56] For example, one area that is receiving a great deal of attention as a way to create jobs in the recovery phase is sustainable finance. During the market turmoil in the first quarter of 2020, sustainable funds attracted record inflows. ESG funds attracted net inflows of USD 71.1 billion globally between April and June this year, pushing assets under management in these products to a new high of just over USD 1 trillion (Morningstar, 2020).[57]

A recent Oxford Smith School paper concluded that "progress on climate change will depend significantly on policy choices in the coming six months."[58] Critically, "the right choices could drive a long-term downward trend in greenhouse gas emissions." In its recent paper on *Sustainable and inclusive: Covid-19 recovery and reform*,[59] the United Nations Principles for Responsible Investment presents a series of recommendations for investor policy engagement and indicative proposals for action, including (i) climate-related policy tools and priorities (environmental) and (ii) policy priorities for purpose, fairness and human rights (social).

As mentioned in Chapter 4, the GEMC is conducting work on Fintech-related issues, with a focus on the use of innovation facilitators i.e., innovation hubs, regulatory sandboxes and accelerators in EMs. The report will set forth recommendations, including guidance as to how securities regulators can develop effective innovation facilitators, which will aim to contribute to the overall development of capital markets in EMs following the pandemic.

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55 MR/15/2020, *IOSCO encourages issuers' fair disclosure about COVID-19 related impacts*, Media Release, IOSCO, 29 May 2020, available at: https://www.iosco.org/news/pdf/IOSCONEWS568.pdf.

56 *Sustainable and Inclusive COVID-19 Recovery and Reform*, Report, Principles of Responsible Investment, 06 July 2020, available at: https://www.unpri.org/download?ac=10839

57 *ESG funds attract record inflows during crisis*, Siobhan Riding, Financial Times, 10 August 2020, available at: https://www.ft.com/content/27025f35-283f-4956-b6a0-0adbfd4c7a0e

58 *Sustainable and Inclusive COVID-19 Recovery and Reform*, Report, Principles of Responsible Investment, 06 July 2020, available at: https://www.unpri.org/download?ac=10839

59 See *Sustainable and Inclusive COVID-19 Recovery and Reform*, Report, Principles of Responsible Investment, July 2020, supra fn No 56

Chapter 7. Conclusion and Recommendations

Developing a capital markets sector is a work-in-progress in most EMs as the markets continuously evolve. Capital markets regulators are thus called upon to continuously adapt themselves to circumstances while ensuring investor protection, market integrity and financial stability. These challenges remain current considering new financial products and the growing use of financial technologies.

Currently, funding via capital markets constitutes a small portion of the way companies finance themselves in emerging markets. As the recent pandemic illustrates, capital markets need to function efficiently to support the real economy.

Each market is different in size and has its own set of characteristics and, thus, there is no *one size fits all* solution. Policymakers, central banks, financial regulators, and market participants, supported by International Organisations (IOs) and Standards Setting Bodies (SSBs), such as IOSCO, should aim to deepen their cooperation to develop capital markets in EMs. Further, a holistic strategy for market development should take into account the necessary sequencing and pace of implementing the reforms, depending on the stage of development of each EM. At the same time, regulation should maintain a balance between innovation and financial stability concerns and provide an appropriate environment for the development of institutional investors.

In light of the preceding analysis about gaps in capital market development in emerging markets and how regulators can address them, we make the following recommendations:

RECOMMENDATIONS

Recommendation 1: Policy makers and regulators should develop a holistic strategy for the development of capital markets.

Capital markets can play an important part in addressing the financing needs in EM economies given their relatively lower level of development at present. Development of capital markets should therefore be part of the overall strategy for the jurisdiction. The strategy could include the following aspects:

- *Coordination among national authorities focused on developing capital markets.* While securities regulators have a key role to play in the development of capital markets, the role of other policy makers, central banks, competition authorities and other regulators is also important. An important consideration is the role of taxation policies, for instance, including the relative treatment of equity and debt as well as the treatment of CIS. Further, many of the measures needed for the growth of capital markets may not be within the remit of the capital markets regulator and might have prudential elements (e.g., involvement of pension funds, insurance companies and banks in the capital market). Other aspects that may benefit from a coordinated approach are financial literacy and education as that is a key element for retail investor participation in capital markets.
- *Addressing preconditions for capital markets development.* As mentioned earlier, robust provisions with regard to Company law; Commercial Code / Contract Law; Taxation Laws; Bankruptcy and Insolvency Laws; Competition Law; Banking Law; and Dispute Resolution System are important preconditions for capital market development which should be addressed jointly by authorities.
- *Implementing international standards*. Differences in the timing and manner in which jurisdictions implement international financial sector reforms must be consistent to avoid

market fragmentation and reduce possibilities of regulatory arbitrage. Policy makers and regulators should work together to ensure consistent and timely implementation of international standards making use of the capacity building and technical assistance programs offered by global standard setting bodies.

- *Promote proper corporate governance standards.* Corporate governance focuses on the rights and equitable treatment of shareholders, information disclosure and the duties of board members and management teams. Regulators should ensure that companies that have accessed capital markets to fulfil their financing needs have clear, transparent, timely and complete disclosure of material information. Proper corporate governance mechanisms will promote a transparent and efficient market and increase investors' confidence.

Recommendation 2: Regulators should seek to ensure that capital markets are fair and efficient for capital raising. Deepening liquidity, increasing institutional investor participation, providing diversified investment choices and ensuring market confidence should be high priorities on their agenda.

- *Deepening market liquidity.*
  - **Primary market liquidity*:*** Regulators and market participants should work together to reduce the concentration of ownership in public listed companies and hence increasing free float levels as well as liberalising the intermediary sector to allow for foreign participation in the market, increasing competition to domestic participants as well as extending the market's reach into the international liquidity pool.
  - **Secondary market liquidity*:*** The measures should also consider introducing market making mechanisms to ensure large volume transactions for institutional investors. Regulators could also investigate their ability to lower explicit transaction costs such as bid/ask spreads, transaction commissions, taxes and fees. These measures are expected to increase market participation and increase liquidity, which will then lower the implicit transaction costs by adding market depth.
- *Developing institutional investors.* Regulators should ensure a level playing field for foreign institutional investors while developing domestic institutional investors. Even though EMs assets are recognised as an asset class for portfolio diversification, EMs continue to be largely under-weighted in well-accepted benchmarks. Equal economic and voting rights and investor protection are still high concerns for foreign investors in the EMs. Use of proper deference arrangements[60] may help ease complexity for foreign investors without introducing risks to domestic investor protection and financial stability, thereby facilitating their participation.
- *Increasing the diversity of available investment products.* A greater diversity and breadth of available products would provide options to a wide range of investors with different trading strategies, risk appetites, and investment horizons. Investors will be also attracted to markets with a range of products available for hedging their existing risk positions, including the use of derivative products. Used properly, derivative products can decrease market volatility and enhance returns for investors. Accordingly, regulators could devise more effective policies and measures to encourage the use of derivative products by institutional investors. Effective risk management parameters should be set, and

[60] FR/06/2020, *Good Practices on Processes for Deference*, Report, The Board of IOSCO, June 2020, available at: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD659.pdf

comprehensive monitoring and reporting systems should be put in place to deter any abuse of these products.

- *Sustainable finance*. The outbreak of COVID-19 could prove to be a major turning point for sustainable investing as one of the solutions of a sustainable recovery. EMs should implement the GEMC recommendations for sustainable finance issued in 2019 and develop efficient supervisory practices to combat greenwashing and other unfair practices in this sector. EMs should stay actively involved in the current discussions about sustainable finance and adhere to future global solutions on sustainable finance disclosures.
- *Developing SMEs segment in EMs*. To do so, regulators should (i) establish regulatory requirements tailored to SMEs for equity and fixed income markets which will help reduce issuance costs; (ii) establish market-making systems; and (iii) encourage alternative methods of financing such as private equity and venture capital. To increase institutional investor demand, securities regulators, exchanges, intermediaries, institutional investors and related government parties could collaborate to develop practices or models that offer higher liquidity for equity and other SMEs securities.
- *Simplify product offering procedures and broaden offering methods.* To further develop the equity and bond markets and broaden the institutional investor base, EMs should seek to expedite the approval or registration procedures for primary issuances and streamline the offering documentation requirements, removing undue administrative impediments. Even if larger companies have more access to capital markets in emerging economies there is a strong need to create more flexibility on offering models. Regulators should also consider, for example, new types of offerings that can be tailored to specific needs, including limited offerings (directed to institutional investors) and private placements (directed to a small number of investors).
- *Diversify distribution channels and encourage competition.* Distribution channels in many EMs are usually highly concentrated, particularly in the mutual fund industry. In many jurisdictions, commercial banks typically dominate mutual fund distribution. High concentration leads to higher bargaining power for certain distribution channels, which makes it very difficult to negotiate lower fees for institutional investors. Regulators should implement policy incentives with an aim to encourage more participation in the distribution channels, including commercial banks, securities firms, independent financial advisers, insurance companies and direct sales. This will translate into higher service standards and lower fees for institutional investors.

Recommendation 3: Securities regulators should have adequate powers, proper resources and the capacity to perform their functions and exercise their powers.

The regulator should be accountable under a jurisdiction’s legal and governing structure and, at the same time, should be operationally independent from external political or commercial interference. Without such independence, investors and other market participants may come to doubt the regulator’s objectivity and fairness, with detrimental effects on the market’s integrity. Furthermore, the regulator should have adequate powers of licensing, supervision, inspection, investigation and enforcement. The regulator should have adequate funding to exercise its powers and responsibilities, and should ensure that its staff receives adequate, ongoing training. EMs regulators should develop and participate in capacity building initiatives as the market is continuously evolving. The staff should be well equipped to comprehend sophisticated products and be abreast of latest developments and challenges posed by capital markets.

The regulator should be able to regularly review whether its current regulatory requirements and framework adequately addresses risks posed to investor protection, and to fair, efficient and transparent markets, as well as to the reduction of systemic risks. A regular review of the perimeter of regulation will also consider the effectiveness of existing regulations and whether they need to be modified or whether new regulations are needed in light of new market developments.

Furthermore, the regulator should have in place efficient supervisory and enforcement programs which, amongst others, will aim to:

- *Ensure efficient supervision of market intermediaries and conduct issues.* Regulators should be effective in their supervision of business conduct and ensure that conflicts of interest and misalignment of incentives are avoided, eliminated, disclosed or otherwise managed. Regulators should proactively supervise and monitor market intermediaries' behaviour and consider conduct implications, particularly during market stress and volatility to detect indicators of emerging conduct threats. Supervisory approaches need to facilitate early detection of stresses in the markets. Intensified supervisory approaches can include developing financial risk indicators, proper risk assessment of firms, and stress-testing frameworks, among others.
- *Prevent market abuse by building sound surveillance capacity.* Market abuse undermines market integrity and investor confidence. Regulators should have comprehensive inspection, investigation and surveillance powers designed to detect and deter manipulation and other unfair trading practices.
- *Ensuring contingency planning for asset managers.* Regulators should require asset managers to have a range of liquidity management tools to allow for the continued orderly management of the investment funds and maintain investor confidence, notably during stressed market conditions. These tools should include,[61] among other things, antidilution levies and swing prices; redemption gates and limits on withdrawals; side pockets; and suspension of redemptions. As mentioned in Recommendation 5 (below), securities regulators should work with other authorities in the interest of maintaining financial stability.
- *Monitor challenges arising from financial innovation.* With new products in the markets and the increased use of technology, there is a need for regulators and market participants to have efficient supervisory mechanisms in place, which could incorporate innovation technologies such as RegTech and SupTech. Innovation should be encouraged and facilitated where it has the potential to improve market efficiency or satisfy unmet demand. Regulators, however, need to monitor carefully, any innovation which involves opacity and improper risk management approaches. Regulators also need adequate resources, proper training and statutory authority to be able to keep close supervision of innovative financial products. Members are encouraged to strike a balance between innovation, diversification and regulation. With the COVID-19 pandemic, an increase in digital technology and the use of cashless payments has been noted above. Capital markets can be further developed by embracing advancements in technology, accompanied by the necessary regulatory policies and structures to support their growth, keeping in mind cyber security issues.

[61] FR01/2018 *Recommendations for Liquidity Risk Management for Collective Investment Schemes*, Final Report, The Board of IOSCO, February 2018, available at: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD590.pdf

Recommendation 4: Jurisdictions should establish strong national and international cooperation arrangements to develop capital markets with the key involvement of the securities regulator.

The IOSCO MMoU and EMMoU have provided the necessary mechanisms through which securities regulators can share with each other essential investigative material, such as beneficial ownership information and securities and derivatives transaction records, including bank and brokerage records for enforcement purposes. Securities regulators are encouraged to continue to exchange information on the basis of these mechanisms and to ensure any additional necessary exchanges of information for supervisory purposes.

Most EMs have also set up mechanisms for information sharing and cooperation among authorities within their countries. Securities regulators should continue to use these mechanisms to exchange information for supervision as well as for the growth of capital markets and for maintaining financial stability.

At the same time, IOs and SSBs, such as IOSCO, should continue to strengthen their cooperation and collaboration, including with regard to the assistance offered to jurisdictions.

Recommendation 5: Regulators working together with market participants should develop and implement efficient roadmaps for investor education and guidance.

Investor education is key for ensuring investor protection and promoting investor confidence. As the financial marketplace continues to evolve and innovate, investment products are becoming increasingly complex and financial services increasingly diverse. Greater understanding of key financial concepts is required on the part of retail investors to understand and evaluate the choices available to them and to avoid financial fraud. Strengthening investor education and financial literacy programs is also essential at a time when responsibility for saving and investing for retirement is shifting from the employer to the individual in many jurisdictions.

It is therefore important for retail investors to be educated, informed and aware of the risks associated with their investment. Regulators and market participants should therefore design and implement detailed programs for investor education. These programs should be tailored to consider specific vulnerabilities of different segments of retail investors taking into account investor behaviours.

Annex 1: List of Acronyms

AA: Administrative Arrangement

AGM: Annual General Meetings

AuM: Assets under Management

BCP: Business Continuity Plan

CIS: Collective Investment Scheme

DLTs: Distributed Ledger Technologies

DM: Developed Market

DMA: Direct Market Access

ECF: Equity Crowd-Funding

EMMoU: Enhanced Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information

EMs: Emerging Markets jurisdictions

GDP: Gross Domestic Product

GEMC: Growth and Emerging Markets Committee

GFC: Global Financial Crisis

IFA WG: International Financial Architecture Working Group

IOs: International Organisations

IOSCO: International Organization of Securities Commissions

ISIM: International Standards Implementation Monitoring

IM: Implementation Monitoring

IMF: International Monetary Fund

LTF: Long-Term Finance

MMoU: Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information

OECD: Organisation for Economic Cooperation and Development

OTC: Over the Counter

P2P: Peer-to-Peer Lending

STP: Seminar Training Program

SSBs: Standards Setting Bodies

TA: Technical Assistance

TNA: Total Net Assets

VCMs: Volatility Control Mechanisms

WIW: World Investor Week Campaign

Annex 2: List of Charts

Chart 1:Market capitalisation in Emerging Markets 4
Chart 2: Bond Outstanding to GDP 4
Chart 3: EM bond issuances in domestic market (total): deal value by bond type 5
Chart 4: Global Bond Markets Size 5
Chart 5: IMF Emerging Markets Financial Development Index 21
Chart 6: EM Debt Issuances (USD millions) 21
Chart 7: Global Financial Conditions Index 22
Chart 8: Portfolio Flows to Emerging Markets 22
Chart 9: Total Net Assets (TNA) of 23
Chart 10: Evolution of Total Net Assets in Investments funds indexed to 1st October 2019 (YTD October 2020) 24
Chart 11: Flows into EMs Investment Funds, by investment strategy – 24
Chart 12: Cumulative flows 25
Chart 13: Decomposition of AuM changes into valuation and flow effects DM and EM....... 26
Chart 14: Exchange rates – Selected emerging market economies, Jan-May 2020 27
Chart 15: Emerging Markets | COVID-19 / Oil-Related Rating Actions 27

Annex 3: GEMC mandate and drafting team

The IOSCO Growth and Emerging Markets Committee (GEMC) was invited to contribute to the IFA WG work program for 2020 which aims to develop domestic capital markets to support growth and enhance financial resilience.

The GEMC mandated its Steering Committee (GEM SC) to carry out the analysis and draft this report, under the coordination of Dr. Obaid Al Zaabi, GEMC Chair and Chief Executive Officer of the Securities and Commodities Authority of the United Arab Emirates (SCA UAE). The drafting team was led by SCA UAE (Ms. Pooja Singh and Mr. Mohammed Al Noukhatha Al Ali), supported by the IOSCO Secretariat. The following members form the GEM SC:

- Comisión Nacional de Valores, **Argentina**
- Securities Commission of The Bahamas, **Bahamas**
- Comissão de Valores Mobiliários, **Brazil**
- China Securities Regulatory Commission, **China**
- Dubai Financial Services Authority, **DIFC, Dubai**
- Financial Regulatory Authority, **Egypt**
- Securities and Exchange Board of India, **India**
- Financial Services Commission/Financial Supervisory Service, **Korea, Republic of**
- Securities Commission, **Malaysia**
- Comisión Nacional Bancaria y de Valores, **Mexico**
- Autorité Marocaine du Marché des Capitaux, **Morocco**
- Securities and Exchange Commission, **Nigeria**
- Securities and Exchange Commission, **Pakistan**
- The Bank of Russia, **Russia**
- Capital Market Authority, **Saudi Arabia**
- Capital Markets Board, **Turkey**
- Securities and Commodities Authority, **United Arab Emirates**