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Challenges in Securities Markets Regulation: Investor Protection and Corporate Governance

Report on a SUERF/CNMV Conference held in Madrid on Friday 11 November 2014

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Conference Report[1]

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Securities markets play an important role in the financing of economic activity. The financial crisis, however, highlighted the risks, which may arise from highly complex, intransparent financial instruments and internationally interconnected financial markets and institutions. Against this background, the issue of how to ensure that financial markets fulfil their functions both for individual participants and for economic systems and societies as a whole is important. The question also gains urgency in Europe in the light of a – real or perceived – scarcity of bank credit arising from regulatory constraints and a wider reconsideration of future bank business models: in this situation, securities markets can provide welcome and useful alternatives at least for medium to large firms to obtain financing, and many observers indeed expect a shift towards more securities markets versus bank financing in continental Europe over the coming years.

Securities markets authorities face the task of ensuring a smooth functioning of securities markets. Apart from operational issues, this has traditionally involved safeguarding fair treatment of savers and investors. This can happen either by ensuring a high degree of transparency on the part of issuers and a high standard of financial education, so that well-informed and educated investors are in a position to make good decisions on their own. Alternatively, to the extent that this approach is not considered to be sufficient, investors may actively be protected from their own unwise decisions and adverse financial consequences, by regulating the scope of financial instruments to be offered to them and by regulating which intermediaries are allowed to sell financial products under which preconditions. Of course, also a combination of these instruments may be used, which is actually the case in practice in most countries. To shed light on these issues and the challenges in the years ahead, SUERF – the European Money and Finance Forum and CNMV – Comisión Nacional del

[1] The conference presentations can be found on the SUERF website http://www.suerf.org/madrid2014.

Mercado de Valores - jointly organised a conference in Madrid on the topic of "Challenges in securities markets regulation: Investor protection and corporate governance". The conference, which marked the 25th anniversary of the establishment of CNMV, was attended by around 120 academics, regulators, central bankers and financial practitioners from around the world.

Elvira Rodríguez, Chairperson of CNMV, in her welcome speech and introduction offered an overview of the three sessions on protection of retail investors, financial literacy and corporate governance. She thanked SUERF for cooperation in the selection of speakers and in organizing the conference program. **Urs Birchler**, President of SUERF and Professor, University of Zurich, in his welcome address to the participants reciprocated the kind words of Ms Rodríguez and thanked for CNMV's support and for providing the beautiful auditorium of the National Council for Scientific Research (CSIC) as conference venue.

Elvira Rodríguez chaired the first keynote session and welcomed **Sir Paul Tucker**, Senior Fellow, Harvard University, and former Deputy Governor of the Bank of England, who gave the SUERF Annual Lecture on the question "Is there a crisis in securities regulation?". Paul Tucker focused on three themes: of securities regulators. While investor protection and corporate governance are crucial for securities markets regulation, they are not enough. The world' s first securities regulator, the US SEC, put disclosure and enforcement at the core of its mission, and other regulators followed that mode of operation. Particularly after the financial crisis, securities regulators must also focus on securities markets' systemic stability; but so far, this has hardly been done. IOSCO amended their principles and now requires inclusions of financial stability. But implementation is still patchy at best. While securities regulators enjoy some degree of independence, they are influenced by parliaments which approve their financial means and thus their agenda. As politicians like booms, the inclusion of financial stability into financial market regulators' mandate does not happen. The *second* issue concerns *static rulebooks* for securities markets supervisors. Since parliaments hesitate to delegate too much discretion to independent supervisors, they tend to legislate static rules for financial market supervision. However, this is inadequate in two respects. Over time, rules need to be adjusted to allow countering booms and busts. The constant risk of regulatory arbitrage requires constant adjustments in rules to close loopholes. Democracy calls for static rules, while financial markets are inherently dynamic and thus require dynamic rules. The *third* issue is whether rules should be *national or international.* Most securities are now traded internationally. Regulation and supervision of securities markets are only partially adapted to this. Some regulators have designed rules that also include extraterritorial aspects, which, however, do not work with non-cooperative governments. Regulators worldwide recognise this challenge.

Session 1, chaired by **Juan Fernández-Armesto**, Armesto and Associates, was devoted to "Addressing investor protecton issues in retail investment products: more information or more intervention?" **Michalis Haliassos**, Chair for Macroeconomics and Finance, Goethe University Frankfurt and Director of the Center for Financial Studies, identified "Challenges in designing investor and borrower protection", by drawing on his recent research on household finance. Alternatives to regulation include financial education and information campaigns to promote product awareness as well as measures to ensure good financial advice by competent advisors. But it is not (yet) reliably established that financial education leads to better investment decisions, and even if so, it takes a long time to achieve a higher level of such education; and there are clear conflicts of interest in the provision of financial advice. Regulation can address the nature of the product, the users, the mode of using them, and the advisors as well as producers of financial products. It also needs to stipulate sanctions and who stipulates them and to whom (institutions versus individuals). In practice, it is difficult to predict how a particular product will actually be used in the future by particular persons in particular circumstances. At the same time, overly restrictive regulation may amount to paternalism or even discrimination, depriving households of the chance to learn and to benefit from certain potentially profitable investment opportunities. So standardised, product focused information requirements may be the way to go; product "passports" should provide the range of outcomes, including worst and best. Regarding practitioner regulation, certification and proven experience, disclosure of incentives and fees, as well as possibly separating advice and sales functions might help. Summing up, he concluded that a holistic approach including both regulation and measures to ensure transparency and better financial education need to be combined.

Laurent Degabriel, Head of the Investment and Reporting Division, European Securities and Markets Authority (ESMA), explained the relationship between "ESMA and investor protection". He started out by giving five reasons for protecting investors: information asymmetries, insufficient financial education, lack of investors' focus, conflicts of interests of financial institutions, and behavioural biases. So, information is important but not enough. To improve the quality and comparability of information provided to retail investors, the European Union has passed the "Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation. The outcome is a three page key investor document which includes information on total aggregate costs of a product and on risk, including a summary risk indicator and performance scenarios. ESMA is currently in the process of developing regulatory technical standards on the methodologies underlying cost and risk disclosure. Investor protection requires a holistic approach; accordingly, MiFID (Markets in Financial Instruments Directive) II will affect all phases of financial products/services cycles, i.e. the governance of product design and development, the governance of product marketing, including sales incentives, the distribution of products (independent advice, assessment of suitability, organisational requirements for investment firms, execution), and after sale (reporting on costs and charges, complaints handling). MiFID II will strengthen the toolkit available to regulators by providing them with new product intervention powers. MiFID II entered into force on 2 July 2014, the deadline for transposition into national law is 3 July 2016, and from 3 January 2017 MiFID II and MiFIR (Markets in Financial Instruments Regulation) will be applicable.

Theodor Kockelkoren, Member of the Executive Board, AfM and Chairman of the OECD Task Force on Financial Consumer Protection spoke on "Protecting financial consumers and retail products: a case for smart intervention and better information". With the aim of developing key information for financial consumers and finding smart intervention approaches, regulators need to use insights from behavioral science. Intervention in products may for example prohibit teaser mortgage rates, hard to grasp coverage limitations in insurance contracts, and overly complex structured investment products. Another promising route is to intervene in sales and advice practices with a view to reducing adverse incentive structures. In the Netherlands, inducements by product manufacturers to advisors and distributors in order to promote sale of their products were banned in 2013. First results suggest that the inducement ban has fostered competition. Prices have been reduced by as much as 50%. Passively managed funds have become increasingly popular with clients. While previously, distributers negotiated for the most favourable distribution inducement, or retrocession, since the inducement ban, distributors now focus more on finding the most useful tool for their customers. This in turn puts pressure on investment funds to provide efficient and high quality services. Service concepts are now increasingly being differentiated. Before the ban, customers basically had to choose between two extremes: execution only and complete bespoke advice. Now, intermediate forms are being developed, including automated and self-directed electronic advice tools. The inducement ban has also increased pricing differentiation: execution only customers now pay no more than 25 basis points for a very narrow service, compared to 75 basis points paid by full-service customers. In the aggregate, this amounts to savings of 300 million EUR per annum for the customers affected. The share of execution only customers increased from 70% to 75%, while at the same time the share of portfolio management customers also increased from 6 to 11%, at the expense of advice. Apart from the regulatory changes, this may, however, also be due to the fundamental flaw of any financial advice service, which always suffers from blurred responsibility between advisor and customer, as long as the customer is ultimately free to choose what decision to take – when portfolios loose value, relationships between advisors and customers quickly turn sour. Furthermore, in the mass market, financial advice often lacks quality, customers' appetite and ability to take risk is not properly assessed, and advice is often limited to products from the advisor's own financial firm. To sum up, designing smart interventions is not easy and will inevitably involve some degree of trial and error. The Netherlands is currently in such an interesting experiment, it will take a couple of more years of experience to draw some serious lessons.

Juan Carlos Ureta, President of Renta4 and of Fundación de Estudios Financieros, in his presentation on "Beyond information: the role of financial entities in educating investors" held the view that information is the best investor protection. This information needs to be provided by financial firms – not out of philanthropy but for the simple reason that it is the only way to avoid big disappointment, and is thus vital for the business and profitability of financial firms in the long run. Information starts with product names, which should no longer be guided by rosy marketing aims but should be informative about the true nature of the products. The current zero interest rate environment lures people into high risk taking with products they do not properly understand. Also pension and retirement funds should be aware that ultimately they have to provide retirement payments for people and should thus not take on overly risky positions in search for yield. First and foremost, savers need to be made aware of three principles: first, no risk – no yield; second, do not leverage; third, diversify! Finally, protection from low probability big risks (black swans) can only be provided by central banks and regulators.

Session 2, chaired by **Fernando Restoy**, Deputy Governor, Banco de España, addressed the topic of "Fostering financial literacy: experience and perspectives". **Henriëtte Prast**, Professor of Personal Financial Planning at Tilburg University, in her presentation on "Financial literacy and education: facts, fiction and practical implications" chose a quite critical tone about the potential of financial literacy to protect savers from financial mistakes. People suffer from behavioural biases and non-rationality. Most efforts to help people to make better financial decisions in line with their goals focus on directing them away from automatic, intuitive behaviour towards more reflective, analytical ways of thinking. Goals of financial literacy often include financial stability/preventing financial crisis, the financial wellbeing of households, financial inclusion, but also protection against claims by financial customers towards financial firms and advisors. It appears ironical to blame insufficiently financially educated customers for financial crises (as was recently done by the G20). She then emphasized that so far no causal relationship between financial literacy and better financial planning could be established. Personal traits seem to be more relevant for good financial decisions than the level of financial education. Worse, mandated financial education may even have adverse effects, through overconfidence effects. She also criticised a recent statement by the OECD that "…women have specific financial literacy needs…" as being paternalistic. The fact that women empirically have lower scores on financial literacy tests than men could in her view be caused by differences in self-confidence and stereotype threat. She also criticised that the language used in investor communication and advertisements is not gender neutral and may thus put women at a disadvantage. Experiments have shown that self-assessed risk attitudes do not reflect true risk attitudes; in particular, the stereotype that men are more risk loving than women does not live up to the experimental facts. Expenditure on financial education is of doubtful value. Information for customers should not focus on probabilities but on the impact of the individual in the worst case, as set against the ultimate goal to be achieved for the consumer.

Lori Schock, Director, Office of Investor Education and Advocacy, US Securities and Exchange Commission (SEC), offered her views on "The role of regulators in investor education". The SEC was founded in 1934, following the US stock market crash in 1929, with the aims of maintaining integrity of the securities markets, facilitating capital formation and protecting investors. Companies that publicly offer securities must tell the public the truth about their company, the securities they sell and about the risks involved. People who sell and trade securities must treat investors fairly and honestly. In practice, securities markets nowadays have to deal with investors who are nevertheless in charge of their own financial destiny, who are ill-informed and confused by increasingly complex products, and who have lost trust in the markets. The philosophy underlying the SEC's policy is: protect yourself because even if a wrongdoer is caught the funds are often gone. Education can prevent fraud, and educated investors are better able to report suspicious activity. The SEC provides investors with a number of tools to facilitate this: a database of registered entities (including audited financial statements and fees) and salespeople (including customer disputes, regulatory action and an employment and exam history).

Various surveys have shown that most customers do not research titles, designations and backgrounds of financial professionals. However, all in all the website based information service provided by the SEC is visited by many people (1.4 million in fiscal year 2014) at very low cost. The SEC intends to expand its activities in the future by use of social media and traditional media to leverage publicity for investor alerts etc. and also considers a multi-media investor education campaign.

José Manuel González-Páramo, Member of the Board of Directors and Chief Officer, Global Economics, Regulation and Public Affairs, BBVA, explained the relations between "Responsible banking and financial literacy". As a result of the financial crisis, the financial industry is faced with a perceived loss of legitimacy combined with a growing demand for responsibility. There is increasing regulatory pressure, including with respect to customer protection. Dignity of financial industry staff is undermined. The financial industry must therefore aim for a new, sustainable strategy resting on trust, integrity, transparency and prudence. These principles can be summarised under the umbrella term "responsible banking". To win back support from society, responsible banking must be based on full legal compliance as well as good practices and long-term value generation for all stakeholders. Regarding financial literacy, he did not share Ms Prast's scepticism on the value of financial literacy. Financial literacy has an important social value for society and for the financial system by fostering consistent savers and responsible debtors. Financial literacy is a collective task, which needs to involve regulators, educational institutions and also financial institutions. Impact assessment, integration of financial education into products and services and forging partnerships are the most important challenges for financial institutions' financial education activities in the future.

The academic keynote speech "The Nature of Regulation" was given by **Andrei Shleifer**, Professor of Economics, Harvard University. He started by asking why regulation is needed. Some answers can be found in the "Law and Economics" literature. Ronald Coase analyzed in a path-breaking paper (1960) the relationship between parties with conflicting activities and the role of assigned rights and liabilities. "Coase's Theorem" states that if trade in externalities is possible and there are sufficiently low transaction costs, bargaining will lead to an efficient outcome regardless of the initial allocation of property. This reasoning leads to a sceptical view of government intervention. The speaker used an illustrative example with two neighbours with conflicting interests, one who likes having noisy parties, and the other who prefers peace and quiet. As long as legal rules are clear, contracts are enforceable, there is complete symmetric information and there are no transaction costs, private negotiations between the parties will solve the conflict. The two neighbours can pay each other either to abstain from partying or to obtain permission to partying. However, when some of these assumptions are not fulfilled, Coase's Theorem fails. If many parties are involved, meeting costs may be prohibitive. If some parties have much more information than others, negotiations will not work. Liability rules can, however, greatly expand the scope for efficient outcomes. Arguments for regulation should not focus on capture and politics. They should be based on litigation and liability considerations. Important aspects are transaction costs of enforcement, the quality of courts and incentives in particular the impact of litigation on activity. The attitude to regulation depends on the legal origin of a country's laws. The speaker referred to an 1998 article "Law and Finance" in the Journal of Political Economy co-authored by La Porta, Lopez-de-Silanes, Vishny and himself. In the article, the authors distinguish between Common Law, French Civil Law, German Civil Law and Scandinavian Law countries. Common Law countries tend to rely on Coase's line of reasoning, while civil law countries are more prone to regulate. Common Law countries tend to protect outside investors like shareholders, while creditor protection is high in the Scandinavian countries. The impact of legal origins shows enormous persistence over time. People's trust in other people also seems to explain variations in regulation. Distrust breeds demand for regulation. Experience with regulation in developing countries is especially bad. Corruption is a serious problem in many countries. There are enormous cultural and legal variations in the world.

Manuel Conthe, Bird & Bird International Law Firm, chaired the third session "Corporate governance issues in listed companies: do we need a stricter regulatory approach?" The first speaker, **Colin P. Mayer**, Saïd Business School, Oxford University, dealt with "Risk

Cultures in Bank Organizations". Many banks have – according to the speaker - sold wrong products to their customers. Some banks were involved in systematic manipulation of indicative interest rates like LIBOR or demonstrated, prior to the financial crisis, other blameworthy behaviour. The question for regulatory authorities is what they can do about it. The main regulatory response has been to mandate banks to establish risk committees and risk offices. The speaker referred to a bank which could be used as a model for other banks. The Swedish bank Handelsbanken distinguished itself as one of the most resilient banks during the financial crisis. The bank does not pay bonuses to its managers. In the bank, decision-making and risk-taking has to a large extent been decentralized to individual branches. The bank's corporate governance structure does not comply with conventional views on such arrangements. This should, however, not be a matter of concern because the conventional views of corporate governance do not apply to banking. In large banks, it is simply impossible to manage risk centrally. From a systemic risk point of view, it is in fact dangerous if all banks manage risks in the same way. The employees in a bank should share a strong common culture including the attitude that excessive risk concentration should be avoided. Each bank should develop its own risk culture. There is no single right way to manage risk.

Eddy Wymeersch, Chairman, Public Interest Oversight Board, gave a lecture on "Corporate Governance of Banks after CRD IV". Before the 2007-2008 financial crisis, corporate governance of banks was largely voluntary. Bank boards could decide to which extent they wanted to comply with corporate governance codes and recommendations from the European Commission. There were prudential measures in the form of "fit and proper" practices and rules to avoid conflicts of interest. Auditing was mandatory but with a relatively weak link to supervision. The Basel Committee for Banking Supervision (BCBS) had issued an Internal Governance Recommendation. New EU legislation changed the governance environment. Corporate governance of banks is now subject to CRD IV (Directive 2013/36/EU). The role of the board has changed. It is not anymore the agent for the shareholders for maximising their profits. The board is rather in charge of a broader "public interest" objective, including financial stability, risk avoidance and management control. Most provisions are stated as objectives, requirements and processes, but not hard and fast rules. Implementation is national and with oversight by national financial supervisors or by the ECB for large banks. Member states shall ensure that the management body defines, oversees and is accountable for the implementation of governance arrangements that ensure effective and prudent management of an institution. Article 88 in CRD IV does not mention the pursuing of profits. The political debate in the European Parliament has focused on the time availability of board members and remuneration. In accordance with this, the Directive states that the number of directorships of a person should be limited and that remuneration policies should be aligned with the risk appetite, values and long-term interests of the institution. There should also be a maximum ratio between the variable and the fixed component of the total remuneration. The speaker had critical remarks on the complex rules for delinking remuneration from risk. Remuneration levels and practices still vary from country to country. In the US, remuneration of bank managers and the proportion of variable compensation is higher than in Europe.

Antonio Vázquez, Chairman, International Airlines Group (IAG), presented "The View of a Listed Company". IAG is a holding company, which owns the shares of Iberia, British Airways and other airline companies, which together employ 60.000 people. Due to the fact that the group operates in several countries and is listed both in London and Madrid, the board and the managers had to decide which corporate governance code(s) it should try to comply with. Its present corporate governance arrangement complies with both the UK code and the Spanish code. In addition to the corporate governance "soft-law" recommendations, IAG also has to comply with disclosure and transparency requirements in "hard-law". From the company's point of view, it is fair that regulators define the contents of corporate governance disclosures, but companies should also be free to tell their own story in their own way. Corporate governance provisions should only specify some minimum requirements, and regulators should stick to the "Comply or Explain" principle.

Manuel Conthe concluded the conference by thanking the speakers, the chairpersons, the participants and the organizers for their contributions.