



WHY BARBADOS NEEDS A SECURITIES AND EXCHANGE COMMISSION

by

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Introduction

Concurrent with the transformation of the Barbados Financial System, the need for market monitoring is expected to rise over time. Given the ongoing internationalization of securities markets and transactions, it is becoming increasingly important to upgrade the system and strengthen regional co-operation to deal with violation of market fairness which extends beyond national borders.

In upgrading the system and fulfilling responsibilities as regulator, the role of the Securities Exchange of Barbados has become more important and has been extended to its maximum.

This outline seeks to describe the deliverables at which the proposed regulatory reform is targeted and should enhance understanding of the need for a Securities and Exchange Commission and the importance of its presence in the activities of the Barbados Capital Market.

The Need for Capital Market Reform

The development of a vibrant capital market is of critical importance to the real economy and should keep pace with national growth targets while maintaining qualities of integrity, efficiency and innovation, to ensure domestic investor confidence and to attract and retain foreign investment flows. Accordingly, efficient markets are a *sine qua non* for sustainable economic development.

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The Role of the Capital Market

In short, capital markets fulfil three main economic functions:

- i. Serving as a source of long-term capital financing for investment.
- ii. Acting as a monitoring tool in cases where capital has been inefficiently allocated to unproductive investments.
- iii. Acting as an intermediary between savers and users of capital for productive purposes (i.e., borrowers).

It therefore follows that when financial systems are working well, economic growth is strong. When the opposite is true there are long periods of slow and sometimes negative growth. When macroeconomic fundamentals are weak and financial systems are not properly supported, countries could experience capital flight rather than capital inflows which could adversely affect prospects for economic growth as well as social stability.

The Objective

The objective therefore, is to create a market which is credible, transparent, stable, efficient, fair, responsible, competitive and innovative.

Credibility

In order to be described as credible, markets must gain the confidence of participants through effective enforcement and compliance.

Transparency

This is characterised by timely dissemination of reliable information.

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Stability

The lower the risk the more stable the market.

Efficiency

To be efficient, markets must run smoothly through accurate pricing.

Fairness

This calls for the promotion of free competition in markets.

Responsibility,

Once high professional standards are upheld, responsibility will emanate.

Competitiveness & Innovativeness

Effective competition for capital and innovation will come from constant updating and introduction of new products and technology to meet market needs.

Having said all of this, strategy is therefore critical to the attainment of the objective, so that it is of utmost importance to identify and adopt policies which will propel development of markets, in keeping with the above standards.

The policies which the Government has adopted to attain this objective involve inter alia:

- The development of a Mutual Funds industry;
- Tightening of disclosure based regulation by effecting a major shift from most self regulation. (On full implementation of the SEC the SEB as a SRO will only regulate the trading platform and will itself be regulated by the SEC);
- The development of a secondary market for trading Government Paper;
- A complete review of the capital market legislative framework;
- The establishment of a Securities and Exchange Commission (SEC);

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- An upgrade of the SEB through computerization of the trading platform and the establishment of a Central Securities Depository (CSD);
- Implementation of a mass public education programme for the entire market including practitioners, institutional investors and the public at large;
- Planned training programmes for the staff of the SEB and the SEC.

The major challenge for the success of this process is to bolster and sustain investor interest, in order to undergo a meaningful cycle of productive financial intermediation. This would assist in attaining an appropriate regulatory framework, thereby facilitating the process of capital formation for the country in an orderly and sophisticated manner.

On completion of the cycle, financial integration and access to regional and extra regional portfolio flows will lead to profitable investment, provide the environment for policy and institutional reform, and result in greater resilience to market volatility, systemic risk and/or instability.

Approaching the Task

The role of deep efficient capital markets in the growth and stability of an economy is well documented. Statistics relative to depth and breath of emerging markets are often used as indicators of economic development. However, left to themselves, without substantial government involvement, capital markets are unlikely to deepen, improve their efficiency, or increase their activity. In extreme cases, markets will die.

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The Government plays a necessary role in supervising and regulating the financial system. Also, in establishing rules and guidelines to protect the rights of investors, to impose best behaviour by market intermediaries, and to build and maintain confidence and integrity in the system. Efforts to develop and strengthen all facets of the Barbados Capital Market, as well as to promote and facilitate a diversity of products and asset classes have always been on the Government's agenda. Privatization and development of a bond market are also part of the business plan. The need for these plans to come to fruition have been critically underscored in this market by the prevailing low trading volumes, absence of liquidity and overall thinness of the market.

Another challenge is that the pace of Barbados' capital market development must also take into consideration the changing regional and global environment. However, Barbados is fortunate to have most of the ingredients for a functional capital market in place, albeit lacking the sophistication and sensitivity of the larger markets.

Since 1987 this market has seen the introduction of exchange traded equities and, in 1994, Barbados agreed to participate in a project to upgrade and modernise the regional system. Exchange Control, even though not fully liberalized, has been very flexible and supportive to the environment. By the end of this year the SEB should be operating under a fully automated trading system with a computerised Clearance and Settlement. The Mutual Funds Industry will be regularised and new Securities Legislation will be introduced as well as the Companies Act amended to ensure market fairness, efficiency and safety.

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Since it is clear that current investors are more informed than non-investors about the role of the SEB as a Regulator, and information is considered one of the critical components in investor protection, it is important to maintain this reputation by continuing to educate. Otherwise, non-investors will not only continue to demonstrate high levels of "don't know" responses but will also more likely be misinformed about the role of the SEB as a regulator and, by extension, the role of the SEC when it becomes a reality in the not too distant future.

Current Regulation and The Need for Stronger Regulation

The SEB is the sole Regulator of Capital Market activity. As a Self Regulatory Organization (SRO), it regulates trading activity, administers 'takeovers', mergers, as well as the activities and conduct of market intermediaries and, more recently, the Mutual Funds Industry.

With full implementation of the Harmonisation and Upgrade of Regional Stock Exchanges project, the SEB cannot continue to regulate itself, of itself and by itself, and most importantly with the required levels of efficiency and transparency. Additionally, even though it is clear that the SEB is thought of as a "watch-dog" for the market by those who are aware of its regulatory role, and it currently enjoys a moderate awareness level on an unaided basis (thanks primarily to coverage of trading reports in the print and broadcast media), there is still a sizeable group of local investors who are unaware of the role of the SEB as a Regulator.

While unaided awareness may be considered high, recollection of what was heard or read by those who are aware may be significantly low. A recent survey conducted

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by SEB staff revealed that many people interviewed could not recall what they had heard or read about the SEB. It is also important to note that, of those who could recall, their recollections were not negative nor were they detrimental to the future of the institution. These findings suggest that the investing public needs to be educated about the role of the SEB, since awareness of its existence seems to be disproportionately high in comparison to awareness of the actual functions it currently fulfills and/or those responsibilities which it should be fulfilling. Education must therefore be the thread running through all efforts to strengthen and develop the domestic capital market, whether development is to be on a physical or regulatory basis.

At the domestic level, regulation is, inter alia, to ensure that issuers, and promoters of securities do not make use of insider information to their own advantage, either to mislead or cheat investors. Although misuse of insider information can invoke the principles of *caveat emptor* (let the buyer beware), failure to address this informational imbalance between the users of capital and the providers of it will ultimately result in a higher cost of capital. This is in addition to the resulting loss of confidence in the market that can be expected to occur, since providers of capital will be poised to demand premium prices to offset their weaker bargaining positions.

In such situations everyone loses, as capital is less efficiently mobilized and productive capacity is retarded within the economy. Even though regulatory oversight may compel timely disclosure this may not fully remove such an asymmetry although it can minimize it if appropriate penalties and incentives are in

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place.

At this time, the SEB has no power to investigate, penalize nor enforce. Hence the need for appropriate third party oversight in the form of a SEC to form the sole basis on which an efficient capital market will function. The Commission should provide the necessary foundation to effect practices necessary for the efficient functioning of a modern emerging capital market. Building on the current legal infrastructure and introducing new Securities Legislation, this regulatory authority will maintain the fairness and integrity which currently pervades, while at the same time enhancing its safety and efficiency.

The hypothesis therefore is that without regulation, the market could continue to develop and grow but would also be open and vulnerable to external imperfections. Fair markets are equitable, providing protection from abusive practices such as money laundering and fraud. Efficient markets are competitive and have suitable infrastructure and the up to date information systems necessary for quick accurate dissemination of information such as real time prices.

On the macroeconomic side of the equation, regulation ensures that information is produced on a regular basis, that it is comprehensive, accurate, timely and widely disseminated among participants in an efficient and equitable manner, in order to mobilize capital to finance economic activity.

Technological Impact

The speed at which capital markets currently function and the size and complexity of transactions increase the associated risk. Therefore, in spite of the low

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percentage of market errors, the possibility of system-wide cascade in the event of default or failed trades on one side of the system arouses great concern. Given the anticipated increase in the volume of investment in capital markets, such an eventuality could be extremely costly and could have serious repercussions for the economic growth and activity of all participating countries as well as their dependents. Following from this point, there

is therefore a need for independent regulatory oversight to ensure systemic integrity and maintenance of stability.

Globalisation

Barbados cannot afford to ignore the fact that with globalization, the world's financial markets will eventually integrate, with serious consequences to be faced by any unprepared markets. The potential therefore for emerging markets such as ours to compete in the global economy will depend on both regulators and market participants to respond quickly and efficiently to changes and demands by the marketplace.

Globalisation will not continue to marginalise countries or leave them behind hoping one day to catch up; they will be forced to drop out of the race completely. Globalisation of financial transactions will require regulators to be more creative in finding methods for monitoring threats to systemic stability and the financial pulse of the market.

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Having said this, as entrance is made into international markets, maintaining

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systemic stability and the ability to respond to globalisation and financial integration are issues of great concern. It must be recognised that advances in technology have shortened communication channels while widening the choices of financial products available to cater to the specific needs of investors. Unfortunately however, regulators have not yet found a yardstick of measurement nor a checklist to be used in preparing capital markets for globalisation and financial integration. Preparation therefore requires a concerted effort by governments and regulators, along with the co-operation of capital market intermediaries, in order to attempt to address the wide range of issues which involve improving the market infrastructure and regulatory framework.

Concluding Comments

Right up to the present, Government has provided the financing and support for the SEB as a regulatory body. It has also assessed the SEB's capabilities and its integrity as these relate to the regulatory function. The conclusion drawn by these authorities is that, in order to ensure continued fairness, integrity and confidence, in tandem with development and growth, within the market, there is an urgent need to focus on strengthening the regulatory framework. Otherwise, the market will be incapable of managing systemic stability and maintaining its financial integrity, both at the domestic level and cross-border.