

*Keynote Address*

## **Challenges to Effective Regulation**

LILIA R. BAUTISTA\*

### **Introduction**

There is no mistaking it: in recent years, the global political and economic order has been rattled, and it has been rattled in a number of fundamental ways. The cut-and-dried policy prescriptions of neoliberalism which used to command widespread support have been challenged and reconsidered as many of its showcases and promises—the East Asian Miracle, the New Economy, unfettered markets that would bring unparalleled growth and prosperity to all—have proven to be illusory.

In place of the optimism and certainty that characterized the previous decade, we find ourselves today in a limbo of sorts. Joel Seligman, Dean of the Washington University in St. Louis' School of Law, hit the nail on the head when he wrote: "Today, the fundamental challenge is managing change in a world that is robustly dynamic but whose current direction is unclear" (Seligman 2000: 210).

Having said that, I do not believe that this in-between state we currently find ourselves will last indefinitely. Eventually, the path before us will be made clear, and today's gathering is, I believe, a very critical step in that direction. Whether or not we are able to go the distance will depend on the extent to which we are able to adequately reorient our way of thinking and doing things, to fit the realities we are currently facing.

Today, I should like to highlight three realities which—from my vantage point as a government regulator—I believe is important for government in particular to keep in mind, as we take our first step towards blazing a new trail in regulation and competition.

---

\*Chairperson, Securities and Exchange Commission, Republic of the Philippines.

Speech delivered during the International Conference on "Challenges to Development: Innovation and Change in Regulation and Competition" held on 13-15 October 2003 at the EDSA Shangri-La Hotel, Mandaluyong City, Philippines.

### **Reality No. 1: New Geography of Power**

The first reality which I should like to highlight is that today's political and economic systems, as one writer so aptly puts it, "face a new geography of power" (Sassen 2000). This shift in power has been driven primarily by the twin forces of market liberalization and globalization, which have radically changed the role of state versus non-state actors. More specifically, liberalization and globalization have diminished the traditional role and authority of the state, while bolstering the role and authority of private market actors in governance, not only at the domestic level but at the transnational level as well (Howlett 1999; Beslie 2000; UN 2001; and Sassen 2000). Corporations, or as one writer puts it, "corporation nation states," (Beslie 2000) now have a stronger voice and a greater hand in influencing the content and direction of government policy, including that of regulation.

The other influential group of actors which has emerged in the wake of the state's diminished authority is civil society. Civil society has taken on a growing range of responsibilities, which were previously the exclusive province of the state, and like private market actors, they now command more influence in policymaking and governance, particularly at the domestic level.

Apart from the growing role and authority of private market actors and civil society, a trend towards international convergence in policies and standards has likewise diminished state's autonomy to set domestic policy. This is perhaps best exemplified by the impact World Trade Organization (WTO) has had on the capacity of states to exploit domestic policy space.

The upshot of all of this is an erosion of the state's traditional role as the dominant actor in domestic and international relations, as well as in its capacity to autonomously effect change in their citizen's lives through policy measures (Howlett 1999). What is ironic is that state authority and autonomy have diminished at a time when it is most needed, and indeed demanded, by the layman and the general public. To quote Underhill and Zhang (2003: 3):

The process of global (financial) integration and opening of domestic economic space have severely compromised...the autonomy of national governments in managing their macroeconomic variables, deploying social welfare policies and making strategic choices about the character of their respective societies. While state autonomy in macroeconomic and social policymaking has been constrained, citizens of democracies continue to hold their political leaders to account for policy changes that they are less able to influence. The national responsibility of democratic governments for the socioeconomic security of their population has not diminished. If anything, that responsibility has become greater as the transnationalization of (financial) structures has subjected domestic groups to growing market risks and the dislocations of constant economic restructuring. But the increasing inability of national

policymakers to address the consequences of globalization and to meet rising demands from citizens for enhanced social insurance has dented the credibility of governments elected through democratic processes.

Think this reality over and you will realize that, while market liberalization and globalization may have diminished the authority of the state, it has not made the state obsolete, contrary to the predictions made by some pundits in the previous decade. If anything, in the eyes of the general public, having a state that can effectively provide protection and regulation had grown in importance.

### **Reality No. 2: Market Forces Do Not Always Produce Desired Outcomes**

The importance placed on the state has been brought about largely by the second reality which we have come to grips with in recent years, namely: that market forces will not always produce the most efficient and equitable distribution of wealth and opportunities, and that even market-based incentives can sometimes lead to perverse outcomes.

Take for example, the lessons which financial liberalization offered. During the heyday of liberalization in the 1990s, many countries believed in the promises of financial liberalization—that it would lead to a more efficient allocation of capital; that it would help international investors diversify their risks; and that it would impose greater monetary and economic discipline on national governments (Blecker 1999). Many also believed that these benefits would come automatically, and that financial liberalization by itself would be advantageous to all countries.

Put into practice however, financial liberalization turned out to be much more unwieldy. Experience has shown us that financial liberalization does not lead to automatic benefits. Too often, we have watched borrowed capital move into non-wealth creating activities such as real estate properties, and overambitious corporate expansions supported by ludicrous leverage ratios. As a result, financial activity has become uncoupled or disjointed from real economic activity. Martin Khor's estimates would show that, in the 1990s, close to US \$1 to 2 Trillion worth of short-term capital was shifted around the world in a day; of this amount, only one to two percent was accounted for by foreign exchange relating to trade and foreign direct investment. The rest was for short-term investments that could move very quickly, as well as for speculation (Khor 1998).

Not surprisingly, external financial shocks have become more important than other types of external shocks (for instance, abrupt changes in terms of

trade) in explaining the financial and real instabilities of many economies (Studart 2001). And while financial liberalization per se, may not have been responsible for financial crises, it certainly seems to have increased the probability of crises. In fact, nearly every financial crisis in the world has been preceded by financial deregulation and liberalization of capital transactions (Raghavan 1998, citing the findings of UNCTAD's Trade and Development Report 1998). Moreover, financial liberalization has made it easier for the resulting economic problems to spread much faster and wider.

We have learned the hard way that the relationship between financial liberalization and development is much more complex; that the benefits from financial liberalization are not automatic; and that there are real costs to financial liberalization.

We have also learned that, to benefit from liberalization, a number of preconditions must be fulfilled, and this is where financial regulation plays a key role. Regulation that would define an optimal process of sequencing liberalization; build supply capacity; make our domestic industries better able to respond to emerging opportunities and threats; and mitigate any adverse impacts or adjustment costs which liberalization may have on the public.

Where market failures are prevalent and market forces are therefore insufficient to produce desired outcomes, there is clearly a role for regulation to play. But this brings us to the question of how to regulate, and what incentive mechanisms to use. These days, there is a preference for market-based incentive mechanisms as opposed to the traditional "command-and-control" method, where it is government that sets the rules to influence behavior. This preference is based on the presumption that market-based incentive mechanisms are less distortionary, require less monitoring, and are less corrupt because they reduce the opportunities for discretion and arbitrariness (Nikomborirak 1997).

While this presumption makes sense intuitively, recent events have demonstrated that market incentives are sometimes insufficient to discipline self-interested behavior, and can in fact lead to perverse outcomes. Nowhere is this better illustrated than in the corporate scandals which hit corporate America in 2002.

Take, for instance, the case of stock options. In theory, granting stock options as part of executive compensation packages was supposed to align the interests of management with the interests of stockholders. In practice, the granting of stock options had a perverse effect and provided an incentive for misstating accounts. With personal wealth tied so closely to the price of stock, it was in the executives' interest to boost the share price in the short run, and this is exactly what they did. Corporate executives came to command such wealth through the abuse of the stock option.

Corporate scandals in 2002 also illustrate how industry self-regulation may sometimes be insufficient to make private market actors toe the line. The U.S. Accounting Oversight Board was created precisely because the accounting industry had failed to police its ranks.

### **Reality No. 3: The Challenge of Finding the Right Balance**

Thus far, I have posited that despite the new geography of power which has reduced the state's authority and autonomy, the state still has a critical role to play in regulation, particularly in light of recent experience which has taught us that unfettered market forces do not always produce the desired results, and even market incentives can sometimes produce perverse outcomes.

At this juncture, you may be wondering: Is she suggesting that state regulation is superior to market forces, and that we should therefore have more of it? My answer to your question would be: No, far from it. Current realities clearly indicate a role for the state in regulation, but this does not mean that state regulation is superior to market discipline, and that regulation should therefore be the exclusive province of the state. Neither does this mean that more regulation is called for, only that more *effective* state regulation is needed. The challenge lies in finding the right balance.

And finding the right balance is crucial because there are certain things which are not likely to change and therefore have to be taken as given—the role of the private sector and civil society is not likely to diminish. There is no turning back the tide of market liberalization and globalization. Governments will still feel the pressure to adopt more market-oriented reforms, and it will be increasingly difficult to deviate from liberal market values because the threat of losing out from the gains of global market is very real. Given these realities, the state alone cannot effectively operate or regulate using the traditional hierarchical command-and-control system; rather, the effectiveness of the state will depend on whether it can negotiate with, persuade, engage, and involve private market actors (Pongsin 2001).

In other words, sometimes, the state will have to take the lead. Sometimes, it will merely have to nudge private market actors in the right direction; and sometimes, it will have to accept that, in some cases, market forces are still the best form of regulation. The appropriate role for the state should therefore be dictated less by theory or ideology and more by practicality; or, in the words of Malcolm Sparrow (2000), by tactics, rather than doctrine.

It is this very principle of finding the right balance which guides the Securities and Exchange Commission (SEC) in its mandate of regulating the

Philippine capital market. A very good case in point would be our current initiatives to promote corporate governance reforms in the Philippine corporate sector, which the SEC spearheaded with the promulgation of the Code of Corporate Governance in April 2002.

The Code of Corporate Governance is an example of how governance reforms, while seemingly being imposed by the regulator, may be perceived within the context of voluntariness on the part of those required to adopt them. The SEC could have taken a more heavy-handed approach to the implementation of the Code by making compliance with *all* the provisions mandatory. Instead, in most areas covered by the Code, the principles are merely laid down to serve as reference points which corporations can use as basis for drawing up their own manuals of corporate governance. This leaves adequate flexibility for companies to adapt their compliance to their peculiar circumstances.

Nonetheless, there are certain provisions in the Code which are mandatory for certain covered corporations, such as the requirement to appoint independent directors in the case of listed and publicly-held corporations, and certain provisions to ensure the independence of the external audit, for instance, the requirement for external auditor rotation.

Since the promulgation of the Code last year, we have fast-tracked our reform agenda and issued additional rules and guidelines to give more substance to the principles embodied in it. Compliance with some of these rules, such as the adoption of international accounting standards, is mandatory. But in all of these cases, the SEC has limited mandatory compliance to those reforms in areas where market incentives are either weak or lead to perverse outcomes, and where financial institutions lack capability to sufficiently regulate themselves.

In cases where we believe that it is best to work under the presumption of regularity, we have been more than willing to let the private sector take the lead. For this reason, we have allowed covered companies to have the first crack at monitoring their compliance with the Code of Corporate Governance, by implementing the self-rating system which allows them to measure their own compliance with governance practices. We have taken this track in the belief that, if companies are to really live by the principles of corporate governance, they should be willing and able to police themselves.

Although the submission of the Self-Rating Forms will be followed by random on-site audits by the SEC, the intent of these audits is not to question or challenge the results of the self-assessment, but to expand upon or clarify responses to the checklist. In so doing, we hope to highlight areas for improvement and suggest measures which the companies could take to strengthen their own compliance.

Having said that, however, the SEC has consistently emphasized that we will not be taking these on-site audits lightly. If we should find any evidence of misrepresentation, we stand ready to impose the appropriate sanctions. In this manner, we shall continue to perform our mandate, firm in the belief that for SEC to succeed in its role as a regulator, the implementation of reforms must be a collective effort: a systemic-based implementation that is initiated by law, but sustained with the cooperation of the regulated.

### Conclusion

I have spoken at length about the changing demands on regulation in the midst of three very pressing realities, and I have shared with you how SEC has tried to address these realities in our own initiatives to regulate the Philippine capital market. I am sure that in the course of this three-day conference, many more ideas will surface not just from the vantage point of the state, but more importantly from the vantage point of the private market actors, civil society, and the academe.

From these discussions, I sincerely hope that you will come away from this conference with a new and more effective approach to regulation, one that is rooted in the many realities which we face, and one that finds the right balance—between the actors involved, and between theory and strategy.

Let me therefore close by sharing with you Malcolm Sparrow's thoughts on the craft of regulation:

In the essence of Craftsmanship, we should be able to deliver many acts, not just one ... Regulatory craftsmanship is about having a whole bunch of different tools. The essence of craftsmanship is having them all, knowing how to use them, and being quite judicious when you will use each one (Sparrow 2000: 13, 17).

### References

- Beslie, Laurent  
2000 Rise of the Corporate Nation-State. *Christian Science Monitor*. 10 April.
- Blecker, Robert  
1999 Taming Global Finance: A Better Architecture for Growth and Equity. <http://www.epinet.org/books/taminges.html>
- Howlett, Michael  
1999 Internationalization, Policy Subsystems, and Policy Change: Understanding the Variable Effects of Globalization. Paper prepared for the World Bank Conference of the Global Development Framework.

- Khor, Martin  
1998 *The Economic Crisis in East Asia: Causes, Effects, Lessons*. Third World Network.
- Nikomborirak, Deunden  
1997 A Government's Role in Regulation in the 21<sup>st</sup> Century Economy. *TDRl Quarterly Review*, 12(1) (March): 24-27.
- Pongsiri, Nutavoot  
2001 *Regulation and Public-Private Partnerships*. University of Manchester Center on Regulation and Competition Working Paper Series Paper No. 12. October. <http://idpm.man.ac.uk/crc/wpdl149/wp12.pdf>
- Raghavan, Chakravarthi  
1998 Citing the findings of UNCTAD's Trade and Development Report 1998, in "Asia: The Cause of the Crisis."
- Sassen, Saskia  
2000 *A New Geography of Power*. University of Chicago.
- Seligman, Joel  
2000 The Changing Nature of Federal Regulation. *Journal of Law and Policy*, 6: 205.
- Sparrow, Malcolm  
2000 Innovating in a Regulatory Environment. Remarks at the National Environmental Innovations Symposium, 6-7 December. <http://www.epa.gov/opei/symposium/docs/sparrow.pdf>
- Studart, Rogerio  
2001 Integrating Uneven Partners: The Destabilizing Effects of Financial Liberalization and Internalization of Latin American Economies. A tribute to Don Raul Prebisch. [www.ie.ufrj.br/prebisch/pdfs/13.pdf](http://www.ie.ufrj.br/prebisch/pdfs/13.pdf)
- Underhill, Geoffrey and X. Zhang  
2002 Global Structures and National Imperatives: In Search of Normative Underpinnings for International Financial Order. Paper prepared for the Annual Conference of the International Studies Association held in New Orleans, USA. 22-27 March. <http://www.isanet.org/noarchive/underhill.html>
- United Nations (UN)  
2001 Report on 56<sup>th</sup> Session of the UN General Assembly Second Committee, High Level Panel on Globalization and the State.