



# Securities Commission: New Institutional Framework for Supervising Capital Markets

**The efficient financial regulation is a key factor for a harmonious development of our securities market. Notwithstanding the good performance of our financial system, it is necessary to improve the current institutional framework. This bill goes in the right direction while searching to establish mechanisms of balance and counterbalance, guaranteeing the continuity of internal policies and reducing the capture possibility, among other advantages.**

The Executive presented a legal initiative to the National Congress, which aims at reforming the institutional framework of the supervising entity of capital markets, by changing the *Superintendencia de Valores y Seguros* (SVS, in Spanish – Securities and Insurances Supervisor) to a Securities and Insurance Commission. The institution's management would no longer be unipersonal but a collegiate-type one. Likewise, the bill deals with the regulation of the process through which this new agency will issue the rules applicable to the regulated sector, as well as the penalizing administrative process.

The new institutional framework and the focus of the proposed modifications aim at the right direction. When proposing the independence of the new regulatory entity of the government on duty, the purpose is giving higher legitimacy degrees to its decisions, while granting more autonomy and stability to their criteria and decisions over time.

On the other hand, it aims at giving higher legal certainty levels to the agencies being supervised, by ending with the existing merge of the roles of judge and party of the Superintendent, which would allow market agents to be judged by impartial organisms, as stipulated in our Political Constitution. Moreover, positive changes are introduced in the regulation issuance process in pursuit of greater regulatory quality.

The initiative is the first step, in the form of a bill, towards redesigning the regulatory architecture of the financial market supervising agencies. Considering that it could become a precedent for future amendments to the institutional framework of other supervising organisms of the sector, such

as the *Superintendencia de Bancos e Instituciones Financieras* (Banks and Financial Institutions Supervisor), and even be extendible to other regulated markets, we believe that this bill should be widely discussed. In the first place, certain questions arise that will surely be included in the debate: What made the legislator choose the capital market supervising agency as the starting point? Will progress be made towards a regulation that gives up the sectoral regulation model in favor of a model based on objectives or other type? In the following paragraphs, we will try to answer some of these questions together with describing the main contents of the bill.

### Background

Capital markets have played a very significant role in the proper economic performance of our country. Developed capital markets increase the factor productivity and the investment on capital assets and human capital, while allowing a better allocation of financial resources and better access of people and businesses to financing, all of which entail a higher income level. In the light of these benefits, a series of legislative and administrative reforms<sup>i</sup> have been approved in the last years, whose aim is giving more depth and liquidity to the Chilean capital markets<sup>ii</sup>, notwithstanding the pending processes to enhance this development and updating.

The last international financial crisis showed that supervision systems can lose effectiveness in the face of increasing complexity and interconnection of financial markets and agents. This risk can be especially relevant in segmentation-type models of institutional regulation and supervision, like the Chilean one, where the right perception of all the implicit risks in financial relationships is more difficult. The internationalization of the markets, together with greater complexity and sophistication of the industry, show how the borders among traditional supervising segments have been diluted, which is especially true in terms of the supervision of conglomerates. The protection of the financial stability requires a coordinated action of the supervising agents. Therefore, we deem valuable the announcement of the Minister of Finance of sending to the National Congress a bill that would legally create the Council of Financial Stability, today regulated through the executive decree D.S. N° 953 of 2011 of the Ministry of Finance. The legal creation of this institutional framework will allow giving permanence and formality to an official coordination agency between public regulators of the financial sector. This agency would have powers in matters concerning the evaluation and management of systemic risks. Anyhow, these rules shall be carefully analyzed so as not to generate conflicts in relation to the autonomy of other regulatory agencies, and neither diluted responsibilities.<sup>iii</sup>

Regarding the improvements to the regulatory architecture of the financial sector and the securities market, both at the doctrinary level and considering the recommendations of international organisms, it is quite evident today that part of the failures of our supervising system regards the

institutional structure and design of our financial supervisors. In fact, in 2004, the Financial Sector Assessment Program (FSAP) of the International Monetary Fund and the OECD, in 2010 and 2011, detected the insufficient autonomy degree of the regulatory agencies, which is reflected, among others, on the appointment process for the sector's supervisors. On the other hand, there is also consensus in the need of improving the penalizing procedure, expressly envisaging the warranties of due process of law as well as legal claim bodies for this purpose.

Likewise, the market conduct of the agents and the protection of the financial consumer<sup>iv</sup> have gained special relevance from the perspective of public policies. When processes are efficient and transparent and agents rest assured that the committed public faith is being safeguarded, optimal decisions can be made. In turn, financial consumers should rely on suitable, simple and comparable information and have access to quick and efficient dispute settlement methods.

In this context, on the understanding that the Chilean supervision and regulation models offer spaces to make improvements, in 2010 the Ministry of Finance entrusted the analysis of the current system to a panel of experts called "Financial Regulation and Supervision Reform Commission" or Desormeaux Commission.<sup>v</sup> The main proposals of the Commission were the following: (i) Advancing towards a supervision model based on objectives – which we will see in detail further on; (ii) strengthening coordination among regulators for a better management of systemic risks; and (iii) reforming the corporate government of the regulatory agencies, increasing their autonomy, granting them budgetary independence, generating incentives to attract excellence professionals and envisaging accountability methods.<sup>vi</sup>

### **Redesign of the Financial Market Regulatory Agencies: Aspects to be considered**

A new design of the regulatory architecture of the securities and financial market requires the adequate weighing of risks associated to these changes. The compared experience should be revised; however, care should be taken when adopting measures that are seemingly suitable for other financial systems, more complex ones, but maybe not for ours. In turn, it is necessary to consider the experience of nations that have already made reforms to the supervision model, in order to learn from those processes. The existing supervision models are the following:

- (i) The **sectoral or traditional model**, which is based on the institutions' legal status, that is, according to the object for which they were constituted, which determines the regulator in charge of supervising them".<sup>vii</sup> This is the regulation in force in Chile, Greece, México<sup>viii</sup>, etc.

- (ii) The **functional model**, which considers the functions performed by the financial institutions. Each line of business or activity of a market agent is supervised by a different regulator. The biggest challenge of this scheme is the multiplicity of regulators and the higher associated costs. In turn, no regulator has, in itself, enough information to supervise the systemic risks.
- (iii) The **integrated model**, which has a single universal regulator. This model, although it deals with deficiencies of the sectoral model, has also important limitations, among others, the fact that the integrated regulator can become a red tape entity which is hard to manage.<sup>ix</sup> Another risk lies in the ranking of certain supervision objectives to the detriment of other equally valuable and necessary ones for the suitable operation of the markets. This model was applied in the United Kingdom, through the Financial Services Authority; however, it is currently migrating towards a twin peaks type of system.
- (iv) The **regulation model based on objectives** (twin peaks), where the supervisor model is organized in function of two objectives: the regulation of the financial markets' participants; and the prudential regulation of the financial market itself. Thus, there is a financial stability supervisor and another one for the market conduct. Australia is an example of this model.

At compared level, the trend is the discontinuance of sectoral models and a shift towards integrated models or regulation based on objectives. In the decade of the eighties/nineties, the integrated financial supervision approaches were preponderant. However, the crisis of the Northern Rock Bank in the United Kingdom, and the developments in the United States with Bear Stearns, strengthened the arguments in favor of the supervision model called "twin peaks", which is the one recommended for our country by the Desormeaux Commission (through the creation of the Financial Stability Commission and the market Conduct Commission). This model is not dealt with in the reform proposed in the bill, and the reason remains an open question. For the moment, an analysis carried out by the Central Bank of Chile<sup>x</sup> suggests that although it is the most accepted model, there is no empirical evidence of its superiority in case of a crisis. Furthermore, it mentions that "potential benefits of implementing radical changes in the structure of the supervisors should be carefully weighted against the risks of eroding the strengths of the existing financial legislations".

Regardless of the chosen model, it is pertinent to ask how much should the regulation be extended. We should not confound enhancement of our legislation with entering into overregulation dynamics. Overregulation has significant costs, such as compliance ones, as well as opportunity costs related to the loss of business possibilities or discouraging innovation due to regulatory restrains. Overregulation can also entail an implicit moral risk, particularly when it is conceived as an extension of the State safeguards. Therefore, regulation must be based on a clear articulation of the pursued

objectives, introducing only the requirements and tools that are proportional to those objectives, thus preventing the creation of excessive red tape masses, role duplicity or generating competence conflicts among regulators. As a matter of fact, the benefits of regulation should exceed by far the involved costs.

### **Main Contents of the Bill concerning the Securities and Insurance Commission**

The presented bill maintains the sectoral character of our supervision regulatory model. However, it makes substantial changes to Decree Law N<sup>o</sup> 3,538, contained in the Organic Law of the Securities and Insurance Supervisor (SVS), concerning organic aspects of the new institutional framework, and the regulation powers and administrative procedure for the application of penalties. The main contents of the bill are the following:

#### **1. Transformation of the SVS into a Securities and Insurance Commission**

The initiative replaces the unipersonal government of the SVS, which is awarded to a Supervisor who is trustworthy of the President of the Republic, by a collegiate government: the Securities and Insurance Commission. The direction and management of the institution would be taken by a Council of five members: four Directors and a Chairman of the Commission. The Chairman of the Commission would be appointed by the President of the Republic, and he would hold the position for as long as the presidential term is in office. The need is thus recognized to enhance the coordination of his role with the government. The other members of the Council would be appointed by pairs by the President of the Republic, on agreement of 4/7 of the Senate, and they would hold their positions for six years, with periodical partial substitutions, by pairs, every three years.

The Directors, with highly qualified profiles, will not have exclusive dedication, in spite of the fact that there is a list of incapacities and incompatibilities. This point should be carefully reviewed during the discussion of the legal initiative. It is a highly demanding institution in terms of function performance, thereby existing associated capture risks. The question arises whether the chosen scheme derives from the budgetary constraint to rely on suitable directors. If this were the case, greater reflection on the matter would be convenient. Reduced budgets do not collaborate with the objective of attracting skilled and competitive technicians, in addition to other problems.

The bill establishes grounds for discontinuance of the position, including gross negligence in the fulfillment of his obligations, in which case he will be removed by the President of the Republic, on agreement of 4/7 of the members of the Senate on duty, when appointed with approval of the latter.

The agreements of the Commission will be approved by majority rules, requiring a greater quorum for some specific matters.

### **2. Improvements to the Regulatory Process – Issuance of Regulation Applicable to the Sector**

The newly proposed institutional framework would justify the proposal of granting the Commission broader regulatory powers, in order to allow a quicker adjustment of the financial regulation to the challenges imposed by the development of dynamic financial markets.

The purpose is to install an integrated assessment system of the regulatory impact, which would enable to guarantee the quality and opportunity of the issued administrative rules. The Commission shall also be able to count on studies dealing with, among other aspects, the definition of the problem to be solved; the grounds for the regulator's intervention; the evaluation of the regulatory instrument; and the determination of the legal base for promulgating the regulation (an issue which has been widely debated in the doctrine in relation to the regulatory process)<sup>xi</sup>. The rules shall be subject to public consultation, establishing the mechanisms for the committee to receive and study the observations that the public might formulate in their respect. Ex ante assessment and public consultation are positive factors, since they set up as a control of discretionary authority, forcing it to exert its power in a reasonable manner and demonstrating the need and sufficiency of the motivation that originates the rule.<sup>xii</sup>

### **3. Modifications to the Penalizing Process**

The objective in this matter is to enhance the effectiveness of the penalizing process, enabling the judicial review of the decisions made by the supervising entity. In this perspective:

- Investigative functions are separated from the penalizing function. The first one will be submitted to a unit led by a Prosecutor and the second one to the Commission. The Prosecutor shall be designated by the Commission through the system of *Alta Dirección Pública*<sup>xiii</sup>. The role separation is positive, even though the figure of a Prosecutor, with great powers, can be debatable if he does not have adequate control.
- A description of each one of the stages of the penalizing procedure is envisaged, contributing to the transparency and compliance of due process.
- The resolution of the Commission shall be subject to claims before the Court of Appeals of Santiago, which contributes to the control of possible discretionary situations and the compliance with the warranty of due process.

- The mechanism of judicial review is modified (directly before the Court of Appeals) in order to further expedite it.
- New powers are recognized in relation to the pursuit and penalization of infringements.

Since the Commission will have broad powers to interpret the rules of law, imposing their definitions to the regulated agents, it is necessary to fix the limits to the practice of the penalizing power, by clearly and legally stating the guarantees of the regulated agents. On the other hand, rules should be envisaged to comply with the principles of legality and characterization (ex ante clarity of the conducts that are contrary to the legal system), as well as the principles of innocence, of rational and fair proceeding, right to defense, etc.

#### **4. Accountability**

The bill enhances the transparency and accountability standards applicable to this supervising body, including among others the obligation to present annual public accounts, detailing the work carried out by the Commission the previous year, and the challenges and goals for the following year.

#### **Conclusion**

The smooth operation of the financial system is crucial for development and growth, since it performs an important task of intermediation and allocation of financial resources and contributes to the diversification of risks. Thus, the financial regulation, when it is efficient and effective, is an essential factor for the proper and harmonious development of the markets. Therefore, it is extremely important to pay attention to the design of public policies on this matter. The bill goes in the right direction while establishing mechanisms of balance and counterbalance and increasing the technical level of the institution, among other advantages, notwithstanding those issues that need to be improved. The debate shall have to adequately weigh the regulation's costs, trying to give efficient rather than political signals in terms of its quality.

### In brief...

- The efficient financial regulation is an essential factor for the proper development of our securities market.
- The trend observed at compared level is a discontinuance of the sectoral models (such as the Chilean) and a shift towards integrated models or regulation based on objectives.
- The bill does not advance in that direction, but it substantially reforms the SVS, which would be led by a commission with greater independence degrees and more legitimacy; therefore, it will be granted more autonomy.
- The reform also embraces aspects related to the regulatory and penalizing process which, in general, pursuits higher transparency levels and limits the authority's discretionary acting.

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<sup>i</sup> The laws Nr 19,705, 19,768, 19,769, 19,795, 20,190, 20,255, and 20,343 introduced substantial changes to the laws that regulate the capital and financial markets.

<sup>ii</sup> Pfeffer, Francisco. *“Una década de avances en la regulación legal de la actividad económica, especialmente en su vertiente financiera, los desafíos pendientes”*.

<sup>iii</sup> The creation of coordination organisms between supervisors, with powers to safeguard the compliance with the micro-prudential regulation and the financial stability has been recommended by the OECD, the IMF, and was also recommended by the Desormeaux Commission, although with a different outlook to the finally adopted one in the referred decree.

<sup>iv</sup> In the Chilean case, we can highlight the recent promulgation of Law N° 20,555, which granted powers to the National Consumer Service (SERNAC, in Spanish) in matters related to the financial consumer protection.

<sup>v</sup> Mr. Jorge Desormeaux acted as chairman of the Commission, which was also integrated by prominent experts: Arturo Cifuentes, Luis Cordero, Pablo Correa, Alejandro Ferreiro, Ronald Fischer and Arturo Yrarrázaval.

<sup>vi</sup> Report of the Financial Regulation and Supervision Reform Commission.

<sup>vii</sup> Idem, p.29.

<sup>viii</sup> This was the supervision approach in Spain and Portugal before the global financial crisis.

<sup>ix</sup> Report of the Financial Regulation and Supervision Reform Commission, p. 54.

<sup>x</sup> “Report of the Financial Supervision Commission – Analysis of the most relevant proposals”, Financial Policy Division of Banco Central de Chile, April 2011.

<sup>xi</sup> García, José Francisco and Verdugo, Sergio. *“De las Superintendencias a las agencias regulatorias independientes en Chile: Aspectos constitucionales y de diseño regulatorio”*. Revista de Actualidad Jurídica N° 22, July 2010, Universidad del Desarrollo.

<sup>xii</sup> García, José Francisco: *“¿Inflación de Superintendencias? Un diagnóstico crítico desde el derecho regulatorio”*, Revista de Actualidad Jurídica N° 19, January 2009, Volume I, Universidad del Desarrollo.

<sup>xiii</sup> Independent commission for competitive position selection for government services officials. (T.N.)