

**ASIAN DEVELOPMENT BANK**

**TAR: PHI 37712**

**TECHNICAL ASSISTANCE**

**TO THE**

**REPUBLIC OF THE PHILIPPINES**

**FOR**

**STRENGTHENING GOVERNANCE OF  
SECURITIES TRADING MARKETS**

**March 2004**

## **CURRENCY EQUIVALENTS**

(as of 1 March 2004)

Currency Unit	-	peso (P)
P1.00	=	\$0.0178
\$1.00	=	P56.30

## **ABBREVIATIONS**

ADB	-	Asian Development Bank
PSE	-	Philippine Stock Exchange
SEC	-	Securities and Exchange Commission
SRC	-	Securities Regulation Code
SRO	-	self regulatory organization
TA	-	technical assistance

## **NOTE**

In this report, "\$" refers to US dollars.

This report was prepared by D. Kertzman (team leader).

## I. INTRODUCTION

1. The Government of the Philippines requested Asian Development Bank (ADB) technical assistance (TA) to strengthen financial market regulation and supervision by improving the governance of the Philippine Stock Exchange (PSE) and enhancing the regulatory capacities of the Securities and Exchange Commission (SEC) to oversee the PSE and other securities trading markets.<sup>1</sup> A fact-finding mission was fielded from 10-13 November 2003 and held discussions with officials from SEC, Department of Finance, PSE, and other stakeholders. The mission reached an understanding with the Government on the objectives, scope, cost, financing, and implementation arrangements for the TA. The TA framework is set forth in Appendix 1.

## II. ISSUES

2. Sound governance is crucial for capital markets to inspire investor confidence and play an effective role in supporting growth through channeling savings to productive investment. ADB has been active in supporting efforts to strengthen market governance in the Philippines. Previous interventions include support for establishment of an effective legal and regulatory framework, and restructuring of SEC and subsequent capacity building.<sup>2</sup> While an effective regulatory framework is now in place and SEC's supervisory capacity has been considerably strengthened, governance- and capacity-related issues remain to be addressed at the exchange level. The recent listing of PSE shares on the PSE (self-listing) and PSE's planned divestment of shares, along with plans to establish other securities trading markets, present a new set of challenges and will require SEC to develop appropriate capacity to effectively address them.

3. To address governance concerns, the Securities Regulation Code (SRC)<sup>3</sup> includes provisions limiting the participation of brokers on the board of an exchange, requiring an exchange board to include at least three independent directors, mandating PSE to convert from a non-profit member owned mutual organization to a for profit shareholder corporation ("demutualize") within 1 year, and limiting ownership by any one group to no more than 20% of the voting rights of an exchange. Impetus for enactment of the SRC, and these provisions in particular, was provided by a major trading scandal in early 2000. The incident highlighted weaknesses in PSE's ability to perform effectively as a self-regulatory organization (SRO) because it was dominated by broker members and lacked independence in performing its compliance and surveillance functions.

4. The crisis was exacerbated by the PSE board's decision not to impose sanctions on brokers involved in the scandal, leading to the resignation en masse of PSE's compliance and surveillance group. Although some of the compliance and surveillance staff eventually returned, PSE lost considerable expertise and experience as a result of the incident. To address this concern, PSE hired a new director and additional staff for this group. Capacity in this area needs to be built and strengthened to enable the PSE to perform more effectively as an SRO.

5. Passage of the SRC enabled SEC to ensure that the PSE board was restructured to limit the dominance of brokers. PSE was also demutualized in 2001, but continued to be solely broker owned. A key impediment to divestiture and diversification of ownership has been the

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<sup>1</sup> The TA first appeared in *ADB Business Opportunities* (Internet edition) on 27 September 2003.

<sup>2</sup> ADB. 1999. *Technical Assistance to the Republic of the Philippines for Nonbank Financial Sector Development*. Manila.

<sup>3</sup> Republic Act 8799 enacted in July 2000.

reluctance of brokers to sell their shareholdings due to weak market conditions and lack of investor interest (PSE is currently losing money).

6. At the end of 2003, PSE self-listed and, pursuant to an SEC mandate, has begun the process of divestiture and compliance with SRC provisions limiting the extent of ownership by any one group or individual. PSE also submitted a proposal for self-regulation to the SEC, which did not effectively address potential conflicts of interest between the PSE's regulatory responsibilities and its obligation to generate profit for shareholders. In other jurisdictions in the Asia-Pacific region where exchanges have demutualized (e.g., Australia; Hong Kong, China; Japan; and Singapore), key regulatory concerns include the need to ensure that the public interest is safeguarded and the exchange continues to perform its regulatory function.<sup>4</sup> Regulatory approaches to these issues vary and depend upon the prevailing legal framework and regulatory philosophy. In general, regulators review the exchange's governance structure to ensure that the public interest is adequately protected and the corporate structure to ensure that the regulatory function continues to be performed and adequate resources are provided. When an exchange is self-listed, specific arrangements and memoranda of understanding are often developed to ensure regulatory oversight of self-listing. A committee comprised of representatives from SEC and PSE has been formed to develop a new framework for self-regulation to ensure that listing and divestiture strengthens, rather than weakens, corporate governance. The TA is intended to support the work of this committee.

7. SEC lacks experience in regulating a self-listed exchange and will need to develop its capacity in this area. In addition there are plans to establish a fixed income exchange, and rules have recently been issued governing the development and regulation of alternative trading systems. These developments present a new set of regulatory challenges and appropriate regulatory capacity will be needed to effectively address them.

8. The TA builds upon earlier ADB assistance for the capital markets in the Philippines and complements ongoing work that supports development of a forward-looking strategy to develop the nonbank financial sector.<sup>5</sup> SEC is not receiving any other assistance in this area. Implementation of the TA will be closely coordinated with development partners.

### III. THE TECHNICAL ASSISTANCE

#### A. Purpose and Output

9. The TA aims to contribute to the development of the Philippine capital market through the strengthening of corporate governance and improved regulation of PSE and other securities trading markets. The TA will (i) enhance the ability of PSE to perform its SRO function by strengthening its governance structure, procedures, and capacity; and (ii) strengthen SEC's capacity to effectively regulate PSE and other securities trading markets.

10. The scope of the proposed TA will include the following:

- (i) **Governance review of PSE.** This will assess the corporate structure and governance practices of PSE, including a review of the roles and responsibilities of the PSE board.

<sup>4</sup> ADB. 2002. *Demutualization of Stock Exchanges: Problems, Solutions and Case Studies*. Manila.

<sup>5</sup> ADB. 2003. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Republic of the Philippines for the Second Nonbank Financial Governance Program*. Manila; ADB. 2003. *Technical Assistance to the Republic of the Philippines on Support for Nonbank Financial Governance*. Manila.

- (ii) **SRO review.** This will include a review of SRO operations of PSE and identification of appropriate options to address conflicts of interest and enhance independence of PSE's compliance and surveillance functions. A similar review will be conducted for other securities trading markets.
- (iii) **Capacity building component.** For PSE and other securities trading markets, this will include strengthening the capacity of compliance and surveillance staff to monitor compliance with laws, rules, and regulations. The component will include developing SEC's capacity to address new challenges raised by demutualization and self-listing of PSE, and operation of other securities trading markets.
- (iv) **Review of PSE's business operations.** This will include a review of PSE's current fee and cost structures, comparison with the fee and cost structures of other exchanges, and development of proposals to strengthen the profitability of PSE's operations and its ability to attract investors.

## **B. Methodology and Key Activities**

11. The governance review of PSE will include a written assessment of the corporate structure and governance-related practices, and recommendations to address perceived gaps and promote incorporation of best international standards. This will involve close consultation with PSE board members, management, and staff.

12. The written review of PSE's SRO functions will identify appropriate options to address conflicts of interest that may arise in connection with performance of such functions. Other securities trading markets will be similarly reviewed.

13. The capacity-building component will include a written needs assessment for SEC, PSE, and other securities trading markets. A suitable training program will be designed and implemented in consultation with stakeholders and local training institutions. Training arrangements may also include exchanges of experts with appropriate institutions (e.g., other exchanges, securities commissions, etc.) in other countries. Procedural guidelines and training materials will be prepared with the assistance of the domestic consultant to help SEC, PSE, and other trading markets internalize and institutionalize the best practices and procedures.

## **C. Cost and Financing**

14. The total cost of the TA is estimated at \$358,000 equivalent, comprising \$208,000 in foreign exchange costs and \$150,000 equivalent in local currency costs. ADB will provide \$250,000 equivalent on a grant basis, to finance the entire foreign exchange cost and \$42,000 equivalent of local currency costs. ADB's portion will be funded by ADB's TA funding program. The SEC will provide facilities and counterpart support valued at \$108,000 equivalent. The cost estimates and financing plan is attached (Appendix 2).

## **D. Implementation Arrangements**

15. SEC as the Executing Agency for the TA will coordinate and facilitate the effective implementation of the TA. The Implementing Agency (IA) will include PSE. The TA will be implemented over 10 months and is expected to commence in March 2004 and finish in December 2004. The exchange governance and capacity building expert will submit (i) an

inception report 2 weeks after commencement of his/her services; (ii) an interim report no later than 3 months after commencement of services if SEC and PSE agree to implement the expert's contract over a period of 6 months or more; (iii) a draft final report no later than 1 month before submission of the final report; and (iv) the final report after incorporating comments from SEC, PSE, and ADB. The profitability expert will submit (i) a draft final report no later than 3 weeks after commencement of his/her services, and (ii) a final report after incorporating comments from the IA.

16. An estimated 8 person-months of consulting services will be required, comprising 4 person-months of international and 4 person-months of domestic consulting services. The outline terms of reference for the TA consultants are in Appendix 3. The consultants will be engaged by ADB on an individual basis in accordance with the *Guidelines on the Use of Consultants*.

#### **IV. THE PRESIDENT'S DECISION**

17. The President, acting under the authority delegated by the Board, has approved the provision of technical assistance not exceeding the equivalent of \$250,000 on a grant basis to the Government of the Philippines for Strengthening Governance of Securities Trading Markets, and hereby reports this action to the Board.

## TECHNICAL ASSISTANCE FRAMEWORK

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions And Risks
<p><b>Goal</b></p> <p>Improve governance of securities trading markets</p>	<p>Increased investor protection</p>	<ul style="list-style-type: none"> <li>• Policy dialogue</li> <li>• Market indicators</li> <li>• Consultant reports</li> </ul>	<ul style="list-style-type: none"> <li>• Recommendations are appropriate and implementable</li> <li>• Recommendations are accepted by Philippine Stock Exchange (PSE), Securities and Exchange Commission (SEC), and other stakeholders</li> </ul>
<p><b>Purpose</b></p> <ul style="list-style-type: none"> <li>• Strengthen PSE governance structures and procedures</li> <li>• Build up governance-related skills of PSE, other securities trading markets, and SEC</li> <li>• Encourage diversification of ownership by PSE by improving its profitability</li> </ul>	<ul style="list-style-type: none"> <li>• Improved compliance with disclosure requirements and enforcement of rules</li> <li>• Relevant staff trained to more effectively perform surveillance and monitoring functions</li> <li>• Brokers' share in PSE voting rights limited to 20%; outside investors own remaining shares</li> </ul>	<ul style="list-style-type: none"> <li>• Regular meetings with PSE and SEC officials</li> <li>• Review mission</li> <li>• Consultant reports</li> <li>• Public offering/listing, private placement of PSE voting rights to address ownership restrictions</li> </ul>	<ul style="list-style-type: none"> <li>• Resistance by brokers to divestment</li> <li>• Lack of investor interest</li> </ul>
<p><b>Outputs</b></p> <ul style="list-style-type: none"> <li>• Report to assess corporate governance structure and procedures of PSE and appropriate recommendations on how to align them with best international practices.</li> </ul>	<ul style="list-style-type: none"> <li>• Corporate governance structure and procedures of PSE aligned with best international practices</li> <li>• Strengthened disclosure rules and more timely and accurate dissemination of material information to the public</li> <li>• Training needs assessment and plan</li> </ul>		

<b>Design Summary</b>	<b>Performance Indicators/Targets</b>	<b>Monitoring Mechanisms</b>	<b>Assumptions And Risks</b>
<ul style="list-style-type: none"> <li>• Implementation of training based on training needs assessment of PSE, other securities trading markets, and SEC</li> <li>• Report assessing consistency of SEC regulatory framework for PSE and other securities trading markets, and appropriate recommendations to strengthen SEC's capacity as an effective regulator</li> <li>• A report assessing financial condition and health of PSE and recommendations to improve the profitability of PSE business operations; related workshops</li> <li>• Identification of possible follow up project/s</li> </ul>	<ul style="list-style-type: none"> <li>• Memorandum of agreement between PSE and SEC, and SEC and other securities trading markets, delineating roles and responsibilities</li> <li>• Appropriate amendments to regulatory framework for PSE and other securities trading markets</li> <li>• Changes in fees and cost structure designed to improve profitability of PSE's business operations.</li> </ul>		
<p><b>Activities</b></p> <ul style="list-style-type: none"> <li>• Consultations and meetings</li> <li>• Drafting of recommendations, reports, and training materials</li> <li>• Training, seminars, and expert exchange programs</li> </ul>	<ul style="list-style-type: none"> <li>• Significant level of participation and involvement by target participants</li> </ul>	<ul style="list-style-type: none"> <li>• Reports</li> <li>• Asian Development Bank review of reports, missions</li> <li>• Training attendance</li> <li>• Participant feedback</li> </ul>	<ul style="list-style-type: none"> <li>• Appropriate participants sent to attend training</li> </ul>

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions And Risks
			<ul style="list-style-type: none"> <li>• Training needs assessment was accurate</li> <li>• Other regional exchanges willing to participate in expert exchange program</li> </ul>
<p><b>Inputs</b></p> <ul style="list-style-type: none"> <li>• 8 person-months of consulting services (4 international and 4 domestic)</li> <li>• Training</li> </ul>	<ul style="list-style-type: none"> <li>• Timely implementation of technical assistance</li> <li>• Effective interaction between consultants and SEC, Implementing Agency, and other stakeholders</li> </ul>	<ul style="list-style-type: none"> <li>• Consultants reports</li> <li>• Dialogue with SEC, PSE, and other stakeholders</li> </ul>	<ul style="list-style-type: none"> <li>• Competent experts</li> <li>• Government counterpart support adequate</li> </ul>

**COST ESTIMATES AND FINANCING PLAN**  
(\$'000)

Items	Foreign Exchange	Local Currency	Total Cost
<b>A. Asian Development Bank (ADB) Financing<sup>a</sup></b>			
1. Consultants			
a. Remuneration and Per Diem			
i. International Consultants	100	0	100
ii. Domestic Consultants	0	20	20
b. International and Local Travel	10	0	10
c. Reports and Communications	1	1	2
2. Training, Seminars, and Workshops <sup>b</sup>	60	20	80
3. Miscellaneous and Support Costs	0	1	1
4. Contingencies	37	0	37
<b>Subtotal (A)</b>	<b>208</b>	<b>42</b>	<b>250</b>
<b>B. Counterpart Financing</b>			
1. Office Accommodation and Venue/Facilities for Training/Seminar	0	60	60
2. Remuneration and Per Diem of Counterpart Staff	0	30	30
3. Others	0	18	18
<b>Subtotal (B)</b>	<b>0</b>	<b>108</b>	<b>108</b>
<b>Total</b>	<b>208</b>	<b>150</b>	<b>358</b>

<sup>a</sup> Financed by ADB's technical assistance funding program.

<sup>b</sup> The provision of training will be allocated among the Securities and Exchange Commission, Philippine Stock Exchange, and other securities trading markets. Subject to a needs assessment under the technical assistance, training may include expert exchanges with appropriate overseas institutions, overseas seminars/conferences, and local workshops on specialized topics with external resource persons.

Source: Asian Development Bank estimates.

## OUTLINE TERMS OF REFERENCE FOR CONSULTANTS

### A. International Consultants

1. **Exchange Governance and Capacity Building Expert** (3 person-months). The expert will have had substantial experience in capital market regulation, including familiarity with self-regulation issues related to exchanges that have converted from non-profit member owned organizations to for-profit shareholder corporations (i.e., “demutualized”) including those that have listed their shares on their own exchange (i.e., “self-listed”). The expert will do the following:
  - (i) No later than 2 weeks after commencement of his/her services, and in consultation with the capital market and training expert, Securities and Exchange Commission (SEC), Philippine Stock Exchange (PSE), and other securities trading markets, prepare a concise inception report. Include (a) a written work schedule identifying project deliverables, (b) identification of potential impediments to project implementation, and (c) steps proposed to address such impediments.
  - (ii) Develop recommendations on how to better align corporate governance structures and procedures of the PSE with the best international best practices. The recommendations will include, but not necessarily be limited to,
    - (a) an assessment of the existing board structure, including board committees, in relation to the best international practices on governance, and regional standards/models; and
    - (b) proposed changes, as necessary, to the roles, responsibilities, and liabilities of board members and board committees.
  - (iii) Develop recommendations to strengthen disclosure by companies listed on the PSE. The recommendations will include, but not necessarily be limited to, an assessment of existing requirements, sanctions, and procedures for monitoring disclosure, and recommendations to address perceived gaps therein.
  - (iv) Develop recommendations to strengthen compliance and surveillance by PSE and other securities trading markets. The recommendations will include, but not necessarily be limited to,
    - (a) identification of options to effectively address conflict-of-interest issues related to self-regulatory responsibilities of PSE and other securities trading markets, including promotion of the independence of their compliance and surveillance group, and issues related to self listing of the PSE; and
    - (b) appropriate delineation of oversight responsibilities between SEC and PSE (including responsibilities related to PSE's self listing), as well as between SEC and other securities trading markets.
  - (v) Develop recommendations to strengthen SEC oversight of PSE and other securities trading markets. The recommendations will include, but not be necessarily limited to,

- (a) assessment of SEC capabilities to supervise PSE as a listed company and recommendations on how to strengthen the capabilities; and
  - (b) assessment of the regulatory framework for PSE and other trading markets, and recommendations to strengthen the framework's effectiveness and consistency, including draft rules/regulations and/or amendments thereto.
- (vi) In consultation with PSE, other securities trading markets and SEC, develop a training strategy and plan to support the reforms, based on an assessment of the training needs of relevant staff. Training arrangements may include exchange of experts with appropriate institutions in other countries. Prepare procedural guidelines and training materials with the assistance of the domestic consultant to assist PSE, other securities trading markets, and SEC, to institutionalize the skills obtained.
- (vii) Submit (a) an inception report, 2 weeks after commencement of his/her services; (b) an interim report no later than 3 months after commencement of services if SEC and the implementing agencies agree to implement the expert's contract over a period of 6 months or more; (c) a draft final report no later than 1 month before submission of the final report; and (d) the final report after incorporating and/or addressing comments from SEC, the Implementing Agency, and Asian Development Bank (ADB). Issues addressed in the reports should include, but not necessarily be limited to, the training needs assessment and training program; recommendations to improve governance of PSE; and recommendations to enhance the ability of PSE and other securities trading markets to perform their self regulatory function, and for regulating the PSE and other securities trading markets as self regulatory organizations.

2. **Profitability Expert** (1 person-month). The expert will be familiar with stock exchange operations, including self-regulatory functions, exchange fee and cost structures, and the conduct of profitability reviews. The expert will examine the financial health and profitability of PSE and assess its fee and cost structure in relation to its business activities (as distinguished from its self-regulatory functions) and as compared to other exchanges, including regional exchanges. Based on the assessment, no later than 3 weeks from the date of commencement of services, the expert will submit written recommendations to improve the profitability of PSE's business operations in a draft final report. The recommendations will be submitted to PSE for comment. PSE comments will be incorporated or addressed in the report, and a copy of the final recommendations, including a timetable for implementation, will be provided to SEC and ADB.

#### **B. Domestic Consultant**

3. **Capital Market and Training Expert** (4 person-months) The expert will have substantial capital market experience and expertise, including experience in designing and implementing related training programs. The expert will do the following:

- (i) Assist the exchange governance and capacity building expert to prepare the written schedule for project implementation, update the schedule if any significant event affects project implementation, and submit a written copy of each update to SEC and ADB at least twice monthly.

- (ii) Assist the exchange governance and capacity building expert by preparing background materials, including compilation of related laws, regulations, rules, and procedures of PSE and other public trading markets, and related studies.
- (iii) Collaborate closely with the exchange governance and capacity building expert in designing the capacity-building component. In consultation with the expert, PSE, and other securities trading markets (a) identify suitable local training institution(s), (b) in collaboration with other institutions develop appropriate and sustainable training programs, taking into account funding considerations, (c) identify international and regional training opportunities, and (d) make necessary arrangements for implementing a training program under the TA. Arrangements may include coordination with overseas institutions for exchange programs, visits of resource persons, overseas seminars, local workshops, etc.

4. Based on consultations with stakeholders, prepare a written assessment of training provided under the TA and identify further training needs, for discussion with the Implementing Agency, SEC, and ADB. The written assessment and recommendations for further training needs, incorporating comments of the Implementing Agency, SEC and ADB, will be submitted to the exchange governance and capacity building expert for inclusion in the final report.