Michael Wu

13 The Supervision and Regulation of Securities Markets in Asian Emerging Market Countries

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My presentation today is the Supervision and Regulation of Securities Markets in the Asian Emerging Markets. I am sure there are many of you with better credentials to address this gathering on the subject than I. But, the attractions of an all expenses paid trip to Tokyo clouded my better judgment and I am now here before you like a lamb before the slaughter. I hope you will be gentle with my foolishness and allow this experience to be relatively painless.

As I said, I am no great expert in the supervision and regulation of markets, not in Hong Kong and much less in the Asian emerging markets. All that I feel equipped to do is to talk round the subject by painting a broad picture of the environment in the Region to set the scene for my personal perspective of development and trends.

However, before I commence, as all regulators would insist, I should make a full and frank risk disclosure statement - a little history about my experience in the regulatory business so that you are under no misapprehension about my "level of expertise", if any. This ensures that you take what I am about to say with the proper degree of cynicism.

I first came into contact with the regulatory business after the Market Crash in October 1987, not that very long ago. As you may remember, during the October Crash, the Hong Kong market was closed for nearly a week after dropping about 10% on Black Monday. When it re-opened the following Monday, the market fell by a further 35% and the Hong Kong Futures Exchange clearing system came under

severe stress when nearly half the participants in the futures market walked away from their obligations. It was only saved from bankruptcy through two rescue operations involving nearly $4 billion.

In the wake of that crisis, the Hong Kong Government set up a Committee to undertake a post-mortem. The job spec required a full report on what happened, what went wrong and how to fix it, all within six months. This was a tall order even for experts! An impossible task for a generalist civil servant like myself. I guess they were looking around for someone to be the fall guy if the whole exercise turned out to be a mess. As I was "expendable" as the saying goes, their eyes fell on me and I was given the task. I believe this to be the case because until then I had zero knowledge of the industry, not having ever invested in the securities and futures market prior to that and had little to commend myself for the job at hand. Nevertheless, I was given my marching orders and told to get on with the task. To be fair, they did put together a team of advisers, consisting of people in the industry and other professionals, to act as a sort of steering committee to oversee the project.

Having regard to my training, I did the usual thing a lawyer would do in such circumstances: become an instant expert by reading whatever books on the subject I could lay my hands on. That was another mistake - the first one was agreeing to take the job at all! The books were clearly not designed to educate. They were totally unintelligible to a lay man as they were filled with technical terms and unexplained jargons. What's more, they were all about how the developed markets in the West should in theory work. There was nothing on how markets in practice worked and not a word about how to regulate emerging markets in Asia.

A week later, I was so despondent that I treated myself to a round-the-world trip. I chose my favourite cities - New York, London, Tokyo and Singapore "to talk to market experts". That was my third consecutive mistake because I spent the next ten days getting in and out of airports, flying from one place to another and fighting a serious bout of jet-lag.

By the end of the trip, the only thing I found was that I had lost a precious month. What I thought was going to be a relatively simple task of obtaining consensus from experts regulating the most important international markets in the world on an ideal regulatory system which Hong Kong could copy, turned into a nightmare of multi-coloured strands all shooting off at different tangents. Every place I visited appeared to have a slightly different system:

- the US and UK had dedicated professional regulators while Japan and Singapore were regulated by civil servants;
- the US, Japanese and Singaporean regulators were paramount while the UK had just undergone "Big Bang" and devolved most of its regulatory authority to a plethora of SROs;
- the US relied heavily on black letter laws, the UK on the so-called "raised eyebrow", while Japan and Singapore relied heavily on administrative edicts;
- the US and Japan had Glass-Steagall, the Germans and Swiss went the other way and had universal banking while the UK and Singapore were somewhere in the middle;
- Japan and Singapore had fairly high capital requirements for their intermediaries, the US had moderate requirements while the UK had fairly minimal requirements;
- the US market had specialists, the UK had market makers, the Japanese had *Saitoris* and Singapore had the MAS; and
- the US and UK were quote driven markets while Singapore had an order matching system and Japan was somewhere in between.

I can go on like this for hours, but I shall not bore you further.

Suffice it to say that not only did I find the content and form of regulation varying substantially from jurisdiction to jurisdiction, I also discovered that even the level and style of regulation in these markets differed tremendously. Yet, all these places are perceived to be well-regulated and each set of regulator honestly believed that their system was entirely appropriate. How was I going to rationalise the lot into a coherent picture?

At that stage, I was desperate. I still remember sitting in gloom watching my wife and daughter play with the new Monopoly set I bought them for Christmas. Suddenly, I noticed something odd in their game which did not quite mesh. So, I watched a bit more carefully until I discovered what they were "doing wrong". Rather than buying the place you first visited and paying on those owned by others as prescribed in the Rules of the Game, they simply took money from the bank everywhere they went.

As a diligent father, I tried to teach them how the game should be played. My wife jumped up and asked what was the fun in bankrupting a three year old? And besides, she asked, what was the point of a game with a child if the only result was to make her unhappy? So, she simplified the rules to see how fast they could together bankrupt the bank and then count the money they each made in the process. That way, they could both enjoy the game and also teach my daughter to count a bit.

I thought about it for a while and said to myself, how true! There is no rhyme or reason why you had to follow the rules of the game prescribed by other people. You could always adapt these to your own circumstances to achieve your own objectives. The key to how you should adapt these rules was of course in having clear objectives.

The universal end game in Monopoly was to bankrupt someone, anyone. The end game in securities regulation was equally universal: investor protection and systemic integrity, admittedly with some bankruptcies along the way although that is totally unintentional. These objectives applied across the markets irrespective of the form, style and level of regulation. The differences between the different markets were simply nuances or variations of the same theme. At the end of the day, they merely reflect differences in circumstances and the level of maturity of the markets. What is more, decisions regarding what level these should be pitched at boils down to a question of balance and the choices are simply your day-to-day public policy decisions which we administrators are best at.

With that sorted out in my mind, I set off to do the job at hand. We completed our study within the prescribed time-table and made

some two hundred and forty recommendations to reform the market. I can honestly say that I emerged from that experience unscathed and unencumbered by any deep knowledge of how markets work or how they should be regulated. Moreover, the few years between then and now have passed by without my acquiring any more technical expertise on how best to regulate or to supervise the modern financial markets. So, you have been properly warned.

Now, to the business at hand: The Regulation and Supervision of Markets in the Region.

Generally speaking, I believe it is probably not unfair to say that with only a few exceptions, the Asian financial markets are all fairly new and recently developed. The question that many of the policy makers face at this initial stage of a market's development is "Do I go for a high level of market integrity *ab initio*, thereby running the risk of slowing down the pace of development?" or "Do I go for incrementalism, sacrificing some degree of investor protection but facilitating the pace of development of the market?" To put it another way, the choice is between the desire to start off with a higher level of protection for the relatively unsophisticated investors or to have a level of regulation which does not hamper or stifle the development of the market.

While the two objectives are not necessarily incompatible, they do often conflict. Clearly, the more tightly you regulate a market, the more difficult it is for people, investors and intermediaries alike, to enter the market, thus, slowing down the pace of development. On the other hand, the more lenient the regulation, the easier it is for people to enter but, you tend also to let in the rogues and so expose your investors to a greater degree of risk.

For most markets, Hong Kong included, the choice is rather obvious because you clearly need a market of sorts before there is anything to regulate. There is simply no sense in having a comprehensive and fool-proof regulatory system if you do not have a viable market. This is particularly true because I believe it is overstating it to say that investors will not enter a market which has little regulation. The financial market is all about risk/reward and experience tells us

that the money will follow where there is the right return to justify the risk and this is irrespective of popular perceptions regarding whether a market is "properly regulated" or not. So, even the most conservative pension fund will invest some of its money in the so called "exotic markets" if the expected returns are perceived to justify the risk. Thus, for many years, while the Hong Kong market was termed a "cowboy market", the international players were there punting away merrily with the greatest gamblers of the East, the small local retail investors of Hong Kong.

Their participation in the Hong Kong market undoubtedly contributed to the growth of our market, particularly its level of sophistication. But, they also brought with them some unique problems, particularly exceptional volatility, as the international funds ebbed and flowed through the market. This is because such funds are extremely fickle: they chase after the latest "hot" market without any sense of loyalty or sympathy. As they move in and out of a market, prices and volumes surge or fall as the case may be. But, that is a reality we have to live with.

Here, I would like to digress a bit and talk very briefly about market volatility. Because of the relatively paternalistic style of most governments in the Asian Region, there is very often a higher inclination to protect their retail investor base. This desire sometimes translates itself into a paranoia about market volatility, especially among civil servants who have little knowledge of how markets work. I remember being asked by a senior government official in the Region about how best to "regulate volatility": the US idea of circuit breakers, the Japanese style limit up/limit down or the Korean method of a contributory intervention fund. I was caught by total surprise and did not know how to answer, at least not in sufficiently diplomatic terms to avoid embarrassment to my Government.

He had clearly come to the wrong person for an answer to what was a legitimate question. He had obviously forgotten that we in Hong Kong are the most free-wheeling market-oriented economy in the world and frown at anything that even remotely smacks of

interference with the market mechanism. We live and die by the creed that any such action renders the price discovery function of the market ineffective and cannot be contemplated. For this reason, we in Hong Kong are relatively insensitive to the presence of volatility in our markets, particularly as we firmly believe that the worst thing outside an inactive market is a predictable market. In any event, regulating totally predictable markets is a thankless task as those with the heavy artillery, i.e. substantial funds to play the market, inevitably wins to the detriment of the small retail investors, the people most regulatory systems set out to protect.

The real answer to market volatility in our view is greater diversification, both in terms of products and in terms of sources of investments.

The full complement of financial products, particularly derivatives, presents the market with a wide range of risk diversification and risk transfer tools, thereby making the market more stable, systemically speaking of course; while a variety of sources of investments affords the market with a diversity of views and perceptions regarding prospective trends. As these interact in the market, hopefully they cancel each other out as the sentiments of one particular segment or another change. This way it should be possible to avoid wild fluctuations in the market. These factors, coupled with a robust risk management system, helps to ensure systemic stability even in times of extreme market volatility.

However, recognition of the fact that we have to live with highly volatile markets means that the Hong Kong regulators tend to have to monitor the exposures being built up in the market much more closely than our colleagues in the West. Also, we have to go to greater extremes to satisfy ourselves that these exposures are adequately covered on a market-wide basis.

I stress "on a market-wide basis" here because securities regulators are resigned to the fact that at some point or another, some intermediaries will go to the wall. Unlike banking regulators, we make no attempt to stop such occurrences, although we do try our

best to avoid them where possible. The thing that we have to do is to ensure that when a firm goes down, it does not bring the system down with it. That is the essence of systemic integrity.

Thus, as markets mature, you inevitably start to worry about market integrity. For one, as the market grows to a certain size, concerns regarding the build up of risks in the market begin to rear its head. A simple lesson from Barings' collapse last year is that you should never allow a single player to have half of your open interest however big it is and whatever its financial resources. The business activity they offer may be attractive but you are sitting on a time bomb. To ensure that this does not occur, you need safeguards and systems.

For another, the market will refuse to grow beyond a certain size unless the institutional investor, particularly the international institutional investor, is willing to come into the market in a big way. Very often, they, especially the large US pension funds, are prohibited either by law or their constitutive instruments from entering a market in a major way unless the market is regarded as "well regulated" and systematically sound. Thus, to attract these investors, you have to start getting the market onto a more solid basis by introducing appropriate regulation.

Most of the markets in the Region are actually at this second stage. The roots of their markets have taken hold and their markets are steadily expanding. They are now devoting energy to improving their supervisory standards and regulatory capabilities to enhance market integrity.

To those who are looking at how best to achieve this, a warning note from my 1987 experience: while it may be tempting to look West for inspiration in this process, you should bear in mind that their systems operate within a totally different environment, an environment which more often than not cannot be replicated in the Region. Thus, wholesale importation of so-called international regulatory systems and standards into the Regional markets are totally inappropriate.

Take, for example, the disclosure-based system in the US. It works there because they have a sophisticated information system

that operates real time so that disclosures of price sensitive information in the market place are quickly disseminated. A highly developed research and market analysis industry help digest the information so that their assessment of the implications of such disclosures are reported equally widely and the market can then react to the news in a timely manner. Such a system, particularly the research and analysis capability, is basically absent in the Region. But, it is such support services which render the system effective. So, our ability to go to a disclosure-based system is severely handicapped not so much because of the absence of regulatory will or the lack of investor maturity as many Western commentators would have it but because of inherent deficiencies within the industry.

In addition, the developed markets in the West are generally institutional in nature whereas the markets in the Region are still predominantly retail. This difference changes the nature of the market fundamentally because the retail investor tends not to be able to follow the market as closely and is, therefore, much less capable of reacting in a timely manner to such disclosures even if the same machinery exists in our markets.

Furthermore, in the West, ownership and management of companies tend to be quite separate whereas the majority of companies in the Region are still relatively closely-held. This again militates against a disclosure-based system because the natural check and balance between ownership and management of listed securities does not exist in the Region. The policing role is left largely to the regulator in the Region. This puts additional demands on our regulatory and supervisory systems and have the effect of making us appear much more interventionist than is the case. For this reason, the Regional regulator is often perceived to be much more heavy handed when compared with our counterparts in the West.

Finally, my experience in the industry over the past six or seven years is that the level of professionalism of the practitioners in the Regional markets is markedly lower than in the West. This is not meant as a criticism of the abilities of the local practitioners because

the local practitioners can easily hold their own against the best in the world. What I mean is that, for whatever reason, even respected names in the West tend to apply lower standards when they operate in our markets and would, very often, decline responsibility where these are assumed by them without question in the course of their daily business in their home jurisdictions. The net effect of this is that the quality of some of the disclosures of the companies in our markets and particularly the reliability of the so-called "independent advice" tend to be much lower than in the West. This, too, militates against adopting such an approach in the Region.

The combination of these differences is that the built-in safeguards or the so-called self-regulatory function of the players in the market is much less dependable in the Regional markets. To afford our investors with the same degree of protection, this difference again obliges our regulators to be much more interventionist when supervising market activities than appears to be necessary in the West.

A fact that we have to be alert to when considering how best to regulate and supervise our markets is that the retail investor in the Region tends to base his investment decisions much less on economic fundamentals and research than his counterpart in the West. Markets in the Region are much more "rumour driven". This has two major implications for regulators: the first is that there is a much greater tendency for prices and volumes of individual stocks to cascade as rumours fly through the market, wreaking temporary havoc on short-term market volatility and threatening systemic stability. Intra-day volatilities of up to 10% are common affairs in our markets. Such occurrences outside what they would term as a market collapse are rare in the Western markets. Thus, our risk management systems need to be much more robust.

The second is that surveillance against insider trading becomes much more difficult because nearly everyone appears to be trading on rumours from ostensible insiders, for example, the friend of the wife of the driver of the controlling shareholder. So, our market surveillance team works constantly in overdrive. This also means that

the effectiveness of the Western style moral censure in being identified as an insider trader in the Regional markets is highly questionable within our environment. We are, therefore, obliged to look for alternative responses to such malpractices.

Another fact that we should be alert to is that the Asian investor tends to be much more disinclined towards divulging his investments. He will go to great lengths to hide his shareholdings, even where there is no regulatory motivation for doing so. As a result, our markets are much less transparent. This makes a nonsense of the client identity rules which are standard in the West and renders regulation of takeovers and mergers much more difficult. In addition, minority shareholder protections, such as regulation of non-arm's length transactions, are much less effective in our markets.

One fundamental difference between our markets and those in the West that I take pride in and a lot of comfort from is that the small retail investor in the Region is much more robust than his counterpart in the West. He will take a loss without flinching as long as he knows that he has not been cheated. In the West, they will run to their regulator, or worse still, their Member of Parliament, crying foul and seeking recompense. For this reason, things like suitability rules and arbitrations are much less developed in the Region. But, I am not sure this is necessarily a bad thing or that it makes our investors less sophisticated. I honestly believe that they are equally sophisticated but in a difference sense - they are street-wise and much more adventurous, making our markets more interesting.

Unfortunately, I also believe that their days are numbered because as our markets open to the West, they are increasingly being pitched against players who have substantially deeper pockets and who have much better resources, rocket scientists and PhDs in maths working with the most advanced computer models. The derivatives explosion in our financial markets during the past few years has also swung the battle against their favour. The danger this holds for our markets is that they will grow disenchanted and leave the market altogether. This would completely change the nature of our markets. The trend

is a reality that we have to contend with unless we can reverse it somehow. We in Hong Kong are currently looking at ways and means to redress this imbalance.

As regulators, we also have to contend with the reality that the markets are getting to such a highly sophisticated level that we are increasingly being left behind. The Hong Kong market, with the variety of innovative products and a large over-the-counter derivatives business, is already at that stage. The other markets in the Region are not that far behind. As the markets get ever more complex and finely balanced, the important thing is to ensure that we are not left behind too much, at least not to the extent that we lose a handle over the market and become unable to regulate effectively.

We have to recognise the fact that however well resourced we regulators are, we cannot hope to compete with the market in recruiting a similar level of technical expertise into our ranks. Our pay packages are simply not sufficiently attractive. So, we are unlikely ever to achieve parity in terms of technical capabilities with the industry. Moreover, for the sake of market efficiency, we do not believe that we should erect road blocks against market innovation or attempt to regulate out market initiative. This leaves us in a quandary. Traditional methods can only take us so far, while looking West for inspiration has its pitfalls because of intrinsic differences in environment and market make-up. We have little choice but to come up with new answers to improve our regulatory and supervisory capabilities.

As the markets in the Region increasingly integrate, I believe for one that our past approach of independently regulating our own markets is clearly inadequate. Greater cooperation between us is necessary. The Regional regulators should pool their expertise, share experiences and cooperate closely with each other to enhance our limited resources. We also have to constantly improve our individual regulatory know-how to survive.

Just as the days of the small retail investor in the Regional markets are numbered, so too are the days of the generalist regulator like myself.