Tharman Shanmugaratnam: Regulating the capital markets: making market discipline work

Speech by Tharman Shanmugaratnam, Deputy Managing Director of the Monetary Authority of Singapore at the StanChart-Reuters-Business Times Investment Awards ceremony, Singapore, 16 Feb 2001

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The capital markets are undergoing a sea change. Technology and the Internet have opened new channels for investors to access a wide range of investment information and to transact in securities, often without advice or assistance from market intermediaries. Market intermediaries themselves are consolidating, and exploring new business models to capture clients and add value to their decisions. It is a more competitive environment all round, and the margins from traditional financial intermediation have thinned.

Regulators are having to rethink their approaches towards the oversight of the markets in this new and rapidly changing environment. The objectives have not changed to preserve confidence by maintaining fair, transparent and efficient markets, and to minimise the risk of disruptions that threaten the stability of the system. But the methods of achieving these objectives are being refashioned. It is no longer possible for the regulator to root out all that is evil, dangerous or vaguely suspicious before they get to the market. Greater emphasis is therefore being placed on discipline being exercised within the market, and by the market.

Making market discipline work

We have embarked over the last three years on a shift in our approach to regulating the markets from what is loosely called a merit-based regime, under which the regulator judged the appropriateness of securities being made available to the public, toward to a market-driven, disclosure-based regime of regulation. It is aimed at allowing market participants greater choice and the free play to take calculated risks. We have made it clear that the shift in approach will not compromise our reputation internationally as one of the most open, transparent and well-regulated markets in Asia. Market-based regulation will indeed raise standards of business conduct, as is necessary for a more open, competitive and innovative market environment.

Market discipline will not simply be a matter of 'caveat emptor'. The buyer cannot be expected to beware if he is not provided with accurate and accessible information so as to make a reasonable judgement of prospective risks and returns. Neither can he do so if the market is rigged without his knowledge. It follows that ***market discipline requires a system of laws, rules and standards*** to discriminate in favour of companies with high standards of corporate governance and disclosure, and to exact penalties on those who manipulate the market.

Making market discipline work is therefore the responsibility of all participants in the system. Let me briefly outline some of these roles:

- The ***MAS, as the statutory regulator***, will monitor compliance with the laws and regulations that govern the integrity of the markets, seek enforcement of the laws, and propose amendments in order to keep them relevant in a changing market environment. We have undertaken a substantial review of our securities laws in the last year. Insider trading is now both a criminal and civil offence, and we have recently proposed to amend the laws to capture a wider pool of persons who seek to take advantage of inside information. The proposed new Securities and Futures Act (SFA), to be put to Parliament later this year, will contain other substantial changes. I will elaborate on one of these, concerning the prospectus registration regime later in the speech.[1]
- The ***Singapore Exchange (SGX)***, with its frontline interface with the industry and markets, plays a key role in preserving fair and transparent markets. It is responsible for the listing

[1] The SFA would also incorporate the provisions concerning the raising of capital that are presently found in the Companies Act, thereby creating a single compendium of laws governing the securities industry.

rules for companies that raise capital and have their shares traded on the exchange. It is also responsible for ensuring that conditions exist for orderly trading of listed securities.

- The conduct of ***issuers*** themselves is at the core of a system of market discipline. Issuers must take it upon themselves to make full and prompt disclosure of material information. It is not just a matter of meeting the requirements of the law and SGX's rules. It is increasingly in the interests of companies to go beyond the minimum in disclosure standards, as investors become more discerning to the quality of information available to them. A number of studies have shown that the markets have attached an increased premium in recent years to companies which demonstrate sound corporate governance and who are more forthcoming and open with information on their businesses. The so-called 'corporate governance dividend', previously not easily discerned in Asian markets in particular, is now fully visible.

- Market intermediaries play an important supporting role. ***Investment banks, accountants, lawyers and other professionals who advise issuers*** have a duty to provide high standards of professional advice, and to exercise thorough due diligence to ensure that issuers comply with laws and rules, as well as adopt high standards of disclosure. ***Brokers and investment advisers*** likewise, have a duty to provide their investing clients with objective advice that is in their clients' best interests.

- Finally, it is for investors ***themselves*** to take advantage of higher standards of disclosure in making their decisions. Investors and the media also contribute to effective market discipline by calling for more and better quality information from listed companies. Institutional investors such as fund managers play an important role in this regard. They have greater resources to monitor and analyse information, and typically greater leverage on companies to encourage them to improve on standards of corporate governance and disclosure.

The move towards market-based regulation will be given a significant push by the recommendations of two private sector-led committees that were appointed by the Government last year - the Corporate Governance Committee and the Disclosure and Accounting Standards Committee. The committees have recently completed an exercise of public consultation on their preliminary recommendations, and aim to publish their final reports by April.

The development of a market-driven, disclosure-based regime is in progress. It will be naïve to expect an effective system of market discipline to have arrived in a day, or in three years. The transition will cause some uncertainties initially, and even the occasional revanchist call for a return to the regime of the past. Market participants will take time to develop high standards of corporate conduct and disclosure, and to discover the new boundaries. We can expect some of them to test the boundaries in the process, either wittingly or otherwise. But the boundaries of what is permissible to preserve fair and transparent markets should become quite apparent through a few salutary cases, which will help define the new dispensation.

The MAS and SGX themselves have reviewed their respective roles in the new regulatory environment. I will touch now on a number of issues concerning the regulatory functions of the SGX as a demutualised, profit-oriented and listed exchange, and its relationship with the MAS as the statutory regulator.

Can a demutualised, listed exchange regulate the market?

As a focal point of market activity, exchanges have traditionally been accorded the role of frontline regulator of the securities markets. With the demutualisation and public offering of shares by a growing number of exchanges - most recently the Deutsche Borse - questions arise as to whether a listed for-profit exchange is able to discharge its role as frontline regulator competently and effectively.

Conflicts of interest in the regulatory functions of an exchange are not new however. They existed before demutualisation. Members of the former Stock Exchange of Singapore (SES), a mutual body, had to set and enforce rules in the public interest that could negatively affect their commercial interests. The exchange was also expected to conduct effective and impartial supervision of its member-owners. The potential conflicts of interest in these respects were mitigated by the fact that the SES had only a small number of members, accentuating the financial risks that they each faced from a failure of the exchange to properly regulate.

More importantly, the potential conflicts of interest made it necessary for the MAS to take a heavy hand in the affairs of the exchange. The folklore sometimes exaggerated this, so much that some observers attributed every decision of the SES to the mysterious ways of the MAS. But the hidden hand of the regulator was not ideal for developing a mature and dynamic capital market.

Now that the SGX has been demutualised and listed, a new set of potential conflicts arises. While profits were never irrelevant to the SES, they are the primary motive for shareholders of the listed SGX. Share values and dividends also give greater transparency to the business performance and prospects of the SGX, providing the management with greater incentive to raise operational efficiency, and seek competitive advantage. This is as it should be, and is indeed a principle benefit of demutualising and listing the SGX. There will however be concern from time to time as to whether the greater drive for commercial success will reduce the commitment and resources deployed by the exchange to fulfill its responsibility to regulate in the public interest.

The MAS believes that the interests of the SGX are more aligned than divergent with public interest as represented by users of the exchange. ***A fair, transparent and efficiently-regulated market is indispensable to the vibrancy and sustained business success of the SGX***. Serious investors will not trade on an exchange that does not have internationally acceptable rules of listing, trading and settlement, or does not enforce the rules fairly and effectively. The examples of exchanges that have failed to meet such standards and suffered the consequences of investor shunning their markets are well-known. Without the interest and liquidity provided by investors, no exchange will find it easy to attract issuers and to build its business.

Credibility in regulation is therefore a vital commercial asset for the SGX. The board and management of the SGX recognise this fully. Corporate governance of the SGX is not designed to favour short-term revenue objectives at the expense of long-term gains. Shareholders of SGX themselves have it in their interests to hold the exchange to high standards of market regulation, so as to achieve sustained returns on their investments.

MAS-SGX Regulatory Relationship

A demutualised, listed exchange however requires an enhanced role for the MAS in some respects, even as the functions of the SGX and the MAS are more clearly delineated than in the past. The Exchanges (Demutualisation and Merger) Act passed in 1999 was drafted to give MAS the power to issue directives to SGX in the interest of ensuring fair and orderly securities and futures markets, and the proper management of systemic risks. The MAS is the backstop. It is in the position to put things right, where any potential conflicts of interest become real.

The regulatory relationship between MAS and SGX may be broadly defined as follows. MAS, as the statutory regulator, will administer the corpus of statutory law regulating the capital markets. We also maintain oversight of SGX's regulatory responsibilities and seek to ensure that there are no gaps in the overall regulatory framework. The SGX has direct and frontline regulatory responsibilities of the securities and futures markets, and over the broker-dealers who trade on the exchange. This MAS-SGX regulatory relationship applies to all the major areas of regulation:

a. Regulation of capital raising

- SGX defines and enforces the rules that apply to companies that seek to raise capital on the exchange through primary or secondary issues.
- MAS' approval must be sought for any changes to SGX's listing rules. Under the proposed SFA, the SGX will have to notify the MAS of any rule changes 21 days before its announcement. MAS will be able to approve, alter or stop any rule change during that 21-day period.

b. Continuous listing and disclosure requirements

- SGX enforces the continuous listing requirements on companies, to see to it that listed companies maintain timely and adequate disclosure of material information. SGX has the power to suspend and even de-list a counter if a company fails to meet the standards set out in the listing rules.

- Continuous disclosure by listed companies will also become a statutory obligation under the proposed SFA. This means that non-disclosure or late disclosure of material information will be a breach of the law, not just a breach of SGX's listing requirements, and carry either civil or criminal penalty.

c. Market surveillance

- SGX carries out market surveillance to detect unusual trading activities that could reflect attempts to manipulate the market. Such surveillance efforts could also lead to discovery of parties trading on privileged insider information. SGX has the power to suspend or de-list a counter if conditions for orderly trading are found to be absent.
- MAS will carry out independent surveillance on a selective basis, to ensure that SGX is performing its responsibilities effectively.
- The MAS will have the power under the proposed SFA to pursue ***civil prosecution of listed companies which fail to make timely disclosure*** of material information, and of any participants suspected of ***market misconduct***. The recently introduced civil remedy regime for insider trading will be extended to cover other forms of market misconduct such as market manipulation, or the employment of fraud and deceit in dealing. Civil remedy, which lowers the burden of proof against offenders, will complement the present framework of criminal remedy for offences under securities law.

d. Supervision of brokers

- SGX supervises and inspects brokers to ensure that they comply with SGX's rules, are prudentially sound, and uphold high standards of market integrity. SGX has to act swiftly and firmly to deal with any unprofessional conduct by brokers and their representatives.
- MAS conducts continuous off-site review of brokers' operations to check if they comply with statutory licensing requirements. Such off-site reviews will be complemented by MAS' selective, on-site inspection of brokers to assure itself of the competence and effectiveness of SGX's supervision.

Regulation of SGX as a self-listed entity

When the SGX was listed on itself (on its Securities Trading subsidiary), MAS assumed the role of frontline regulator for the listing and trading of SGX's shares. MAS was the approving authority for SGX's listing, and was directly responsible for vetting SGX's prospectus. We are also conducting surveillance of trading in SGX's shares, and monitoring the continuous disclosure of material information by SGX. MAS has powers under the Exchanges (Demutualisation and Merger) Act to issue directives to SGX to resolve any conflicts of interest arising from its self-listing. Such conflicts are also addressed in a Deed of Undertaking to the MAS. In keeping with the Deed, SGX has appointed a Conflicts Committee to deal with such issues, and MAS is the approving authority for the composition of the Committee.

Revisiting the regulatory structure will be necessary

The relationship between the regulator and the exchange is evolving internationally. Regulators are monitoring the effectiveness of self-regulation by the exchanges, and the division of responsibilities between regulators and exchanges. No single model has gained universal acceptance, and no model is regarded as good for all time in any jurisdiction.

The present MAS-SGX regulatory arrangement has major elements in common with that in the major jurisdictions which have seen the exchanges demutualised, and in particular with arrangements in Australia. The UK approach is also similar, except that the Financial Services Authority (FSA) has taken over the listing authority from the London Stock Exchange (LSE). That decision was shaped by the inappropriateness of leaving the listing authority with the LSE when other competing exchanges are emerging in the UK.

We believe that the current arrangements for the regulation and supervision of the securities markets between the MAS and SGX, with an enhanced oversight responsibility for the MAS and

powers to pursue civil prosecution, will prove robust. But we will continually review the arrangement, keep in touch with international practices, and re-calibrate the roles of MAS and SGX where necessary to ensure effective oversight of the local markets.

I would now like to touch on two features of the regulatory arrangement that we have recently reviewed. The first concerns the approval of substantial shareholdings in the SGX; the second, proposed changes in the prospectus registration regime.

Approval of substantial shareholdings in the SGX

The Exchanges (Demutualisation and Merger) Act requires anyone who wishes to acquire 5% or more of SGX to seek prior approval from MAS. This provision recognises the unique and important role of SGX in providing the infrastructure and marketplace for the trading, clearing and settlement of securities and derivatives in Singapore.

Strategic investors

As announced previously, MAS will allow suitable strategic investors who can promote SGX's growth and development to acquire substantial stakes of 5% or more in SGX. How large a stake these strategic investors will be allowed to take will depend on what they are able to contribute to the exchange in terms of business alliances, technology or other ways of supporting the business and infrastructure of the exchange.

Fund managers

In addition, SGX has received indications from fund managers that they would like to hold more significant stakes in SGX than is currently permissible under the 5% cap. Fund managers are key institutional players on the buy-side of the capital markets, and will, as shareholders, add to the diverse range of groups with an interest in SGX's business. ***MAS will therefore generally allow fund managers who invest pools of customer funds to hold SGX's shares beyond the 5% limit***. They will have to apply to MAS for approval first. ***The combined holdings of such a fund manager will be capped at 10%***. A fund manager, however, cannot expect to be represented on the SGX Board unless it has a substantive, strategic relationship with the Exchange.

Proposed changes to the prospectus registration regime

The Companies Act requires every company seeking to raise funds via a public offer to issue a prospectus to inform potential investors of the financial status of the company, its business plans, the risks of investing in the company, and all other material information which will enable them to make informed investment decisions. Currently, companies submit their draft prospectuses to the Registry of Companies and Businesses (RCB) to be vetted for compliance with the Companies Act. Companies applying to list on the SGX will also send their draft prospectuses to the exchange for vetting to ensure that they meet SGX's disclosure requirements.

When the capital-raising provisions in the Companies Act are transferred to the new SFA later this year, MAS will take over from RCB as statutory regulator for prospectus registration. We are now reviewing the prospectus registration regime with a view to enhancing market accountability, and raising the standards of prospectus disclosure.

Under the proposed regime, MAS will register a prospectus not earlier than 14 days and not later than 28 days after an issuer has lodged the prospectus with MAS. ***This period will allow for both regulatory review by the MAS and SGX, and public scrutiny and comment***. (Currently, there is no public scrutiny before a prospectus is registered.) The prospectus will be published on the Internet to give investors the opportunity to scrutinise the prospectus prior to its distribution, and raise any issues of concern. This model is similar to that which has been introduced in the Australian markets.

There will be a more measured approach to prospectus review by the regulator. I was told that SGX currently vets an average of five drafts for every prospectus that gets published. This is clearly not desirable going forward. The review of prospectuses by the MAS and SGX will focus, respectively, on compliance with laws and SGX's listing requirements on prospectus disclosure. MAS and SGX will no longer vet prospectuses with a view to determining if they contain inaccuracies in information or factual

errors. Issuers and their advisers have to bear greater responsibility for ensuring accurate and adequate disclosure.

After a prospectus has been registered, it is proposed that MAS be empowered to issue a stop order and prevent further issues of securities if a prospectus is found to contain misleading or incorrect statements, or to have omitted material information. Investors who have subscribed for securities on the basis of the deficient prospectus can withdraw their applications and have their monies refunded.

The new prospectus registration regime is aimed at placing greater responsibility on issuers and their advisers to meet the high standards of disclosure necessary for the development of more effective market discipline, and a more mature capital market environment. MAS will be seeking feedback on the proposed prospectus registration regime shortly, as part of our public consultation on the draft SFA.

Conclusion

Approaches to regulation worldwide are evolving with the times. An effective system of market discipline is necessary to sustain and promote the growth of open, transparent and competitive markets. Singapore is making substantial changes to its laws, rules and standards to support enhanced market discipline. It will be a process of evolution, but we have made good progress. Succeeding in this endeavour will require effort by both the regulator and all market participants, including issuers, their advisers and investors themselves. It is an indispensable part of our efforts to make Singapore a premier financial hub in Asia, and we have every confidence in getting there.