Ravi Menon: Singapore's approach to the regulation of capital markets

Keynote address by Mr Ravi Menon, Managing Director of the Monetary Authority of Singapore, at the Thomson Reuters 2nd Pan-Asian Regulatory Summit, Singapore, 28 September 2011.

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What do capital markets do?

Distinguished guests, ladies and gentlemen, good morning. And to all our guests from abroad, welcome to Singapore.

Two thousand years ago, in ancient Rome, enterprises contracted with the government to build temples and collect taxes. The enterprises funded these ventures by selling ownership or equity stakes in the form of shares which were readily transferable among the Romans. Later, the Italian city states sourced for funds from their citizens in the form of bonds to finance wars, while merchants sought financing from individuals to procure better vessels for sailing over ever increasing distances. Over time, a market developed to enable holders of bonds and equities to sell their holdings to other interested buyers. Thus was born – what we now call – capital markets.

Since those early days in Imperial Rome, capital markets have spread far and wide across the globe. But the fundamental function of capital markets has remained unchanged – to allocate capital to those who need it and transfer risk to those who are able to bear it. It is the ability of capital markets to efficiently mobilise financial resources that has made possible the large investments needed for the Industrial Revolution of the 18th century, and the risk capital that funded the global Internet Revolution more recently.

Like other markets, capital markets are prone to volatility as demand and supply fluctuate. But unlike other markets, turbulence in capital markets can have far wider consequences on the rest of the economy. From the Wall Street Crash of 1929 to the Global Financial Crisis of 2008, we have seen how dislocations in capital markets can have devastating effects on financial stability, economic growth, and the welfare of citizens.

Capital markets must therefore be regulated, but in a way that does not unduly undermine their efficiency and effectiveness.

This morning, I want to share with you Singapore's approach to the regulation of capital markets.

Why we regulate capital markets

We can think of the capital market as an ecosystem comprising four key components:

- one, issuers – those who issue securities to raise capital;
- two, investors – those who invest in these securities;
- three, intermediaries – those who advise issuers or investors and facilitate the trading of securities;
- four, infrastructure – the platforms or systems through which securities are traded.

Each component of this ecosystem is prone to market failure – hence the need to regulate.

- First, there is information asymmetry between issuers/intermediaries and investors, and investors may be unable to make informed judgments about financial products.

- Second, there is a principal-agent problem, and intermediaries may not act in the best interests of their clients, be they investors or issuers.
- Third, investors are sometimes prone to herding behavior, exaggerating price movements and thereby precipitating market instability.
- Fourth, if issuers and intermediaries take on too much risk or liability that they cannot manage, there will be loss of confidence and market instability.
- Fifth, critical infrastructure may fail, again leading to market instability.

The purpose of regulating capital markets is to safeguard the interests of investors, ensure that risks are kept to an acceptable level, promote efficient price discovery, and maintain confidence in the market.

In Singapore, the regulatory framework for capital markets is underpinned by the Securities and Futures Act (SFA) and the Financial Advisers Act (FAA). Consumers who invest in products or deal with entities that are regulated under this framework will enjoy the safeguards provided under these laws. Together, the SFA and FAA cover each of the four components in the capital markets ecosystem.

Issuers – dissemination of material information

Let me begin with issuers.

A key tenet of capital market regulation is that relevant information is transmitted efficiently for price formation and discovery. Like most reputable regulators, MAS imposes stringent rules requiring issuers of securities to disclose and disseminate all material information. We conduct ongoing surveillance of market practices and undertake rigorous enforcement actions to ensure compliance.

Disclosure

The SFA requires exchanges to develop rules for reliable and unhindered price formation and discovery. First, disclosure must be ongoing. Post-listing, material information likely to affect market prices must be disseminated in a timely and organised manner. For example, a company that makes an acquisition which is likely to have a material impact on its share price must immediately announce it on the website of the Singapore Exchange. Second, disclosure must be accessible to all. Listed companies are prohibited from disclosing material information on an individual or selective basis. These disclosure requirements complement Singapore's statutory provisions on market manipulation and insider trading.

Enforcement …. and its limitations

Issuers and investors alike must have confidence that the ground rules are adhered to when they transact in our markets. Constant surveillance and strict enforcement are therefore critical. MAS takes a serious view of any false statement or omission of material information that misleads the market. We will not hesitate to impose stiff penalties on issuers who have made misleading statements in initial public offerings, or IPOs.

But no regulator can totally prevent fraud or misconduct. Take for instance our experience with S-chips, or Chinese companies listed on the SGX. Many of them are reputable companies and add breadth to our equity capital market. But some of them are not. Since 2006, accounting irregularities or outright frauds have been discovered in 14 such companies listed on the SGX. Most of these cases came to light when the auditors were unable to confirm the companies' cash and account receivables. The counters were suspended pending investigations by special auditors, and investors had to bear the losses. I still get letters from investors who had lost money in these shares. I can understand their frustrations.

Many have asked MAS to do more to bring the full force of our law to bear on the wrongdoers. Let me state the position categorically: MAS will leave no stone unturned to take rigorous action against those who break our laws. But there are real challenges when the fraud is perpetrated by parties outside our jurisdiction. Cross-border investigations and enforcement are intrinsically difficult.

Singapore is not alone in facing challenges with international listings. Co-operation among securities regulators and enforcement agencies in different jurisdictions is therefore critical.

We cannot eliminate fraud. But we can and must ensure that companies that are brought to the market are of good quality. SGX must be rigorous in evaluating the suitability of listing applicants before admitting them. Other stakeholders must play their part too.

- First, directors of the company seeking a listing must exercise adequate oversight of internal controls and ensure the veracity of information disclosed.
- Second, IPO advisers have a legal and professional responsibility to conduct proper due diligence when bringing companies public. They must have a healthy dose of skepticism, and never place their commercial interests above the need to ensure that a company is suitable for a public listing. MAS will not hesitate to take advisers to task for poor due diligence work.

If the regulators, issuers, and advisers each do their jobs well, we can reduce the likelihood of poor quality companies gaining access to our markets.

Investors – safeguarding their interests

This brings me to the second component of the capital market ecosystem – investors.

Well-informed and empowered investors are at the core of a well functioning capital market. Investors will lose confidence in a market where disclosure is misleading and where selling practices are irresponsible.

Safeguarding the interests of investors, particularly retail investors, is therefore a key focus of MAS regulation. But this objective has to be balanced against the need for investors to take ownership of their investment decisions. A regulatory approach that requires issuers or intermediaries to bear all the risks and losses will not work. If investors expect their losses to be always made good, there will be moral hazard and it will encourage reckless investing.

MAS safeguards the interests of investors in five ways:

- First, we demand stringent disclosure of information by issuers;
- Second, we require transparency in the information disclosed;
- Third, we set standards for intermediaries who sell investment products to provide quality financial advice;
- Fourth, we promote investor education, so that investors are empowered to make informed decisions.
- Fifth, we provide affordable and accessible dispute resolution mechanisms for investors who feel aggrieved by the investment process.

Let me take each of these aspects in turn.

Disclosure

There is nothing like disclosure to instill market discipline. In the words of US Supreme Court Justice Louis Brandeis, "Sunlight is said to be the best of disinfectants; electric light the most efficient policeman". Disclosure is about shining that light so that all can see and make informed decisions.

Investors are entitled to accurate and timely disclosure of material information so that they can assess the risks and rewards of their investment. Disclosure works not because all investors understand every word that is disclosed. Disclosure works because it facilitates scrutiny by experts in the market; it is this professional scrutiny that acts as a check on issuers and helps to inform the broader investor base.

Take for example an IPO prospectus. It can typically run into hundreds of pages, with detailed descriptions about the company's business operations, its competitive environment, governance practices, and risk exposures, not to mention a full set of financial statements. Most retail investors cannot easily digest all this information. But the scrutiny of the prospectus by analysts and institutional investors helps to bring to light any significant weakness in the company.

Having said that, I must acknowledge that greater disclosure does not always improve our understanding of investment products. While all material and relevant information must be disclosed, there is a tendency for disclosure to be voluminous and legalistic – often made for the purpose of limiting legal liability rather than facilitating understanding by retail investors. MAS therefore seeks to ensure that information disclosed is not only adequate but also transparent.

Transparency

MAS has sharpened the focus on providing investors information in a clear and concise manner to aid understanding. Earlier this year, we introduced a new regulatory requirement for a Product Highlights Sheet to accompany offers of investment products that come with prospectuses. Its purpose is to convey key risks and product information in plain language and in a simple question-and-answer format. Let me give an example. In one recent prospectus, the right of the investors to cancel their subscription within seven days was spelled out in two rather technical paragraphs using a total of 170 words. In the Product Highlights Sheet, the same point was made in two simple sentences.

Financial advice

The third aspect of investor protection is the provision of sound financial advice by intermediaries when they sell investment products. The Fair Dealing Guidelines issued by MAS require intermediaries to conduct their own internal assessment to ensure that a new product being launched for sale is suitable for its targeted investor base. Intermediaries must also ensure that their representatives have the competencies to understand and explain the product features to their customers.

MAS has introduced new rules requiring intermediaries to assess their customers' investment knowledge or experience before investing in complex products. The rules will come into effect in January 2012. Where an investor does not possess the requisite knowledge or experience, intermediaries must provide appropriate advice. Investors who choose not to heed their advice or insist on buying a product which has been assessed to be unsuitable for them must take responsibility for their decision. This approach recognises that investors' capacity to understand complex products is uneven, while respecting their right to invest as they see fit.

Over the last two years, MAS has conducted surveys and inspections to assess intermediaries' delivery of these fair dealing outcomes. We will use our findings to fine-tune the Guidelines on Fair Dealing.

While MAS has taken these steps to ensure that the financial advisory industry is able to help investors make informed decisions, the best way to instill discipline on the industry is for investors to demand good advice. Singapore's investing public should seek good financial advisers who are prepared to even advise them against buying an unsuitable product. They should be prepared to pay a fee for such advice.

Investor education

Even with the best of disclosure and transparency, investors can make informed decisions only if they have the knowledge and skills to do so. This brings me to the fourth area of investor protection – education.

The centerpiece of Singapore's investor education efforts is the MoneySENSE national financial programme. It was launched in 2003 to raise consumer understanding of basic money management, financial planning, and investment products. Through various seminars and media initiatives, MoneySENSE has reached a large segment of the population since its launch. In the last year alone, MoneySENSE events attracted close to 100,000 attendees while media initiatives reached more than two million people. These events are conducted by industry practitioners, academics, and investor advocates. To-date, Money SENSE has published more than 230 educational articles on its website and in the media. More than 30 consumer guides have been issued and are available online.

While we have made steady progress, much more needs to be done. Most Singaporeans have sound savings habits and are generally responsible in managing credit, but many still do not have a good understanding of common investment products. Every month, MAS receives, on average, about 10 complaints from the public involving the sale of investment products.

I read many of these letters. Sure enough, there are indeed a few cases of inadequate disclosure or mis-selling, which the financial institution concerned should remedy. But there are others where the customer has failed to exercise basic due diligence. These are the most painful letters to read:

- of investors who were attracted by headline returns and purchased products without reading any of the product documentation;
- of investors who willingly signed blank sheets of product assessment forms without realising what they were buying; and
- of investors who insisted on buying risky products even though they were advised that the products were not suitable for them.

It is very difficult to help in cases like these.

MAS will continue to explore ways to equip investors with core financial capabilities. We are currently studying the feasibility of establishing a financial literacy institute to complement existing MoneySENSE initiatives through talks and workshops to reach a larger segment of the population.

We are also reaching out more to students, through the schools. The objective is not so much to instill technical expertise in investment products, but to inculcate good money habits from a young age – being prudent, being alert to risks, being clear about the objectives of investing.

Dispute resolution

Even with well-informed consumers, occasional disputes with those who sell investment products will be inevitable. Hence the final area of investor protection is to provide an affordable and accessible dispute resolution mechanism for aggrieved investors.

MAS has set clear expectations that financial institutions must establish a robust process to resolve customer grievances independently, effectively, and promptly. We also expect financial institutions to investigate and rectify issues related to any widespread complaints on a particular product or selling practice.

This dispute resolution mechanism within financial institutions can be effective only if parties to a dispute act fairly. Financial institutions must police their relationship managers and enforce internal guidelines. Recently, we were alerted to a case where a financial institution tried to salvage its reputation by denying that its relationship manager had recommended a highly risky investment product to an elderly retiree with a low risk tolerance. This is not acceptable. MAS will take firm action against financial institutions for such behaviour.

On the other hand, investors should not make unreasonable demands and expect financial institutions to accede to them. For instance, a consumer demanded that her bank accept her mobile text instruction to reverse a transaction when the message was sent a day after the transaction was executed.

Where disputes cannot be resolved through the financial institution’s internal processes, investors can approach the independent Financial Industry Dispute Resolution Centre (“FIDReC”). FIDReC provides access to an independent and affordable dispute resolution process through mediation or adjudication. This provides the consumer a low-cost alternative to litigation. FIDReC awards are binding on the financial institution, but the investor can choose to reject the award and pursue other options for recourse.

Intermediaries – safety and market conduct

I turn now to the next key component in the capital markets ecosystem – intermediaries. The objective of regulation with respect to capital market intermediaries is twofold: their safety and soundness, and market conduct.

Safety and soundness

We want intermediaries to be safe and sound, in the interest of preserving systemic stability. Intermediaries connect the various parts of the capital market ecosystem. They stand between buyers and sellers, underwrite risks, act as counterparties in risk transfers, and participate as members of clearing houses. The failure of a major intermediary can transmit risks across the system, causing severe market disruption and undermining confidence. Lest we forget, Lehman Brothers was principally a securities firm, not a bank.

MAS regulation cannot rule out the failure of an intermediary. But we can seek to ensure an orderly winding-down process.

The segregation of customers’ funds from the intermediary’s own funds is a key feature of our regulatory regime. Unlike banks which can freely deploy the deposits they collect, capital market intermediaries are required to segregate customers’ assets from their own monies. This acts as a safeguard for customers’ funds should the intermediary fail. Fund managers are required to appoint independent custodians and fund valuation firms, and be subject to regular audits.

Market conduct

The second regulatory outcome we expect from intermediaries is fair conduct. Trades that give a false or misleading appearance of market activity, actions to rig the prices of securities or futures, are all prohibited under our law and severely dealt with.

MAS works closely with the Commercial Affairs Department to take enforcement actions ranging from civil penalties to criminal action. Last year saw the fruition of MAS' first civil penalty court action. We secured civil penalties against a fund manager who was found by the High Court to have window-dressed his portfolio by creating a false appearance relating to the price of one of the component shares. The fund manager and its CEO were ordered to pay a civil penalty of S$250,000 each to MAS, as well as costs of the court action. The decision was upheld by the Court of Appeal.

The assistance that we sought, and obtained, from our foreign counterparts was vital to our success in this case. Similarly, MAS stands ready to assist our international counterparts in their enforcement efforts. Earlier this year, the Australian authorities successfully prosecuted a former fund manager of an Australian bank for insider trading. MAS had referred this case to the Australian Securities and Investment Commission (ASIC) and provided ongoing assistance during ASIC's investigations.

Infrastructure – sound and stable

The final component of the capital market ecosystem is the infrastructure that supports the trading of securities and futures. Capital market participants trade either on a multilateral basis through organised exchanges, or bilaterally with each other over-the-counter or OTC.

Exchanges

The Singapore Exchange and the Singapore Mercantile Exchange operate the systemically-important securities and futures markets in Singapore. They constitute critical infrastructure that must function properly to preserve stability and efficiency. Our laws require the exchanges to maintain sufficient financial, human and system resources, have frameworks and processes to manage their risks, and to regulate and supervise their participants.

OTC derivatives

The OTC derivatives space has traditionally been the preserve of sophisticated financial institutions which are well placed to assess and negotiate trades among themselves. These financial institutions are regulated by MAS and the risks associated with their OTC derivatives positions are taken into account under the respective regulatory frameworks for these institutions.

OTC derivatives, unlike their more standardised counterparts on futures markets, enable customised hedging of risks. Properly employed, they confer significant benefits to the financial intermediation process and hence the wider economy. For example, interest rate swaps enable companies to convert floating rate loans to fixed-rate loans. Companies with large capital investments over a long horizon, such as airlines, shipping companies and infrastructure builders, rely on interest rate hedging tools to manage their financial risks.

But with the rapid growth of OTC derivatives globally, weaknesses in the market structure can contribute to a build-up of systemic risk. We saw this during the global financial crisis. The interconnectedness of OTC derivatives market participants and the limited transparency on counterparty risks can trigger rapid contagion. Under stressed market conditions, this can potentially threaten the stability of the financial system.

The G20 has called for changes to improve transparency and mitigate risks in OTC derivatives markets. The Financial Stability Board has made recommendations under four key thrusts. Singapore is fully committed to implementing these recommendations.

The first thrust is to standardise derivative contracts. MAS is working with the Singapore Foreign Exchange Markets Committee to encourage standardisation of derivative products. The Committee will formulate a code of conduct for financial institutions operating in the OTC market.

The second thrust of the reforms is to mandate central clearing of all standardised contracts. Central clearing mitigates systemic risk through multilateral netting and ensures that the failure of a counterparty does not affect other participants. Since 2006, the SGX has operated a clearing facility for OTC derivatives, covering derivatives contracts for commodities, energy and freight. It started clearing interest rate swaps in November last year, and will clear foreign exchange forwards by the end of this year.

But comprehensive implementation of central clearing is not without challenge. We need to determine carefully the products for mandatory central clearing, particularly those employed by commercial end-users. The cost of clearing can potentially increase their hedging cost, causing a cut-back on needed investment or an increase in unhedged positions. We also need to be mindful that while central clearing removes counter-party risks, it adds to concentration risks. It is therefore critical that central clearing platforms be subject to robust supervision to ensure that they manage their risks effectively. To the extent that these platforms operate across geographical borders, appropriate arrangements for cooperation among national supervisors must be in place.

The third thrust is to move derivatives trading to platforms where appropriate. This will help to improve price transparency. Singapore is a major centre for exchange-traded derivatives in Asia. We are well placed to move more derivatives trades to organised platforms, but the extent would have to take into account the local context, such as product characteristics and participant profiles.

The fourth thrust is to report trades. Mandatory trade reporting enhances supervision of derivatives markets by addressing information gaps. For this to be effective, regulators need timely access to relevant data that can be aggregated. This requires cross-border supervisory cooperation on data access and harmonisation of reporting requirements and standards. But national concerns have led to some jurisdictions setting up their own trade repositories, which could make data aggregation more challenging. MAS is assessing the need for a local repository and the appropriate regulatory regime to avoid duplication.

In recent months, there has been a notion in some quarters that as tighter regulations are proposed for OTC derivatives in the US and EU, activity will flow to centres in Asia that are purportedly less tightly regulated. This is mistaken. Leading centres in Asia – like Singapore, Hong Kong, and Australia – are very much part of the G20 initiative and there is no room for regulatory arbitrage. MAS is fully engaged in the OTC work of the FSB, the International Organisation of Securities Commissions, and the Committee on Payment Systems and Settlements. We will fully implement the OTC derivatives reform agenda.

There must be consistency in implementation across jurisdictions, but there cannot be precise equivalence. The OTC derivatives landscape in Asia and Singapore differs considerably from that in the US and Europe. We have smaller markets and less complex derivative instruments. We have to consider how to implement the G20 reforms effectively while taking into account enforcement issues and the characteristics of our markets. MAS will consult the industry on its proposals for OTC derivatives market reforms by the end of this year. We aim to meet the G20 target to implement the reforms by end-2012.

Conclusion – shared responsibility

Let me conclude.

In regulating capital markets, we are not dealing with a particular industry or a particular type of institution. We are trying to create the conditions within what is essentially an ecosystem, so that its risks are managed and its economic benefits sustained.

But these benefits cannot be achieved by regulation alone. As Winston Churchill puts it, *"If you have ten thousand regulations you destroy all respect for the law"*. There is a limit to how far regulation can go without undermining compliance, not to mention efficiency and innovation.

All components of the capital market ecosystem must play their part. A well-functioning capital market is a shared responsibility. If all stakeholders do their part well, not only will we have fair and efficient capital markets that everyone has confidence in, but we will also make Singapore a competitive and vibrant financial hub in Asia.

Thank you for your attention.