Second Tokyo Seminar on Securities Market Regulations

Summary of Proceedings

The Second Tokyo Seminar on Securities Market Regulations was held at the Asian Development Bank (ADB) Institute in Tokyo between 5-12 April 1999. The Seminar was jointly sponsored by the Ministry of Finance, Japan, the ADB Institute and the OECD. It was attended by senior officials from securities market regulatory bodies from throughout Asia.

In the seminar, experts from the OECD countries, the IOSCO Technical Committee, and international organisations including the World Bank made presentations on basic principles and current issues in securities market regulation. There were also lively discussions between presenters and participants.

Main topics this year include:

1. The Asian currency crisis and its implications on the regulation and development of securities markets
2. Implementation of the IOSCO Principles
3. Methods of supervision of the securities market
4. Issues raised by advanced computerization (issues concerning the Internet, screen-based trading systems, the year 2000 issues, etc.)

Participants in the Seminar also attended the " Round Table on Securities Market Reforms in the Face of the Asian Financial Crisis" as members of the audience .

Welcome and introductions were provided by **Mr. Kazuhiko Fushiya**, Director-General, Financial System Planning Bureau, Ministry of Finance, Japan, **Dr. Masaru Yoshitomi**, Dean, Asian Development Bank Institute, and **Mr. Fujiki Hayashi**, Head of Unit, Outreach Unit for Financial Sector Reform, Directorate for Financial, Fiscal and Enterprise Affairs, Organisation for Economic Co-operation and Development.

Dr. Ruben Lee, Director, Oxford Finance Group, United Kingdom, presented the keynote initial presentation on the topic of "Securities Regulation in Emerging Markets: Basic Issues and Current Concerns". He examined six broad topics: the nature of regulation, the allocation of regulatory power, governance, competition, information, automation, and finally some international issues.

Dr. Lee noted that the standard approach to understanding regulation is to view it as a four-stage process. The relevant goals must be specified, the tools available to the regulator must be assessed, a choice of action must be made, and then the choice must be enforced. Even this simple model of regulation has problems, however it is difficult to specify what the goals of regulation are, there may be ambiguity, and there is frequently conflict between different goals, and also between different mechanisms.

Various alternative theories of how regulation works apart from the standard model were discussed. The first may be termed the regulatory dialectic. It assumes that for some reason a new regulatory rule is agreed. The commercial participants in the market then react to the rule and exploit any weaknesses in it. The regulator, in turn, then reacts to the actions of the market participants. A process of reaction and counter-reaction is thus established in the regulatory environment. A second model of regulation is that it is a vehicle for achieving political compromise between all the various constituencies in the market. At the extreme, a regulator may simply act to promote his own self-interest.

A central problem is how to allocate regulatory power between the relevant government office or ministry, the regulator, and any self-regulatory organisations (SROs) that exist in a market. The costs and benefits of self-regulation were examined in the context, and the benefits stressed. In order to mitigate the adverse effects of self-regulation, five mitigating policies were identified: having transparency of the decision-making procedure, having due process that allows the decisions of an SRO to be appealed, having a diversity of representation on the board of an SRO, requiring regulatory oversight of SRO decisions, and finally resolving conflicts of interest at SROs.

The governance of markets is important. It was defined as answering the questions: Who has what power at an exchange? How and why do they obtain it? and, How and why do they use it? Two governance structures for exchanges were discussed: the cooperative form and the for-profit form. The key elements of a cooperative are that its services are provided only to members, only consumers can be members, and only members can vote. The idealised goal of a cooperative may be thought to be the maximisation of consumer surplus plus producer surplus. The key elements of a for-profit firm are that profits can be distributed, non-consumers can have voting rights, and non-owners can consume the services provided by the firm. The idealised goal of such a firm may be thought to be the maximisation of producer surplus.

The choice of which governance structure is optimal for an exchange depends on the transaction costs to which each gives rise. If an exchange operates a monopoly, it will typically raise price and restrict access to its trading system. The cooperative governance structure can mitigate these costs, as the consumers of the exchange, normally intermediaries, can tell the exchange's management to set prices at the competitive level.

Given that cooperatives operate as democracies, the costs of reaching decisions at the exchange via a collective choice mechanism can be expensive. If an exchange operates in a competitive environment, in contrast, it may be optimal for it to operate as a for-profit firm. There is no need to worry about monopolistic pricing, and the costs of decision-making in a for-profit firm may be lower than in a cooperative. Different regulatory problems arise with different governance structures. The problems of monopoly may, for example, be mitigated by having a cooperative governance structure. Governance should be a commercial not a regulatory decision.

The nature of competition is not simple. In order to understand it in the securities markets it is necessary to define what a trading system is. Dr. Lee identified three key functions of a trading system: information dissemination, order routing, and order execution. The notion of fragmentation was discussed, and it was shown as having various meanings. It might be applied to all three elements of a market. It might mean that a market is unified, or merely its different components are sufficiently linked. It may be used to describe the structure of a market, or to refer to the market's performance. Dr. Lee argued that fragmentation should be used purely as a descriptive term, rather than as a normative term. He then identified and discussed the costs and benefits of fragmentation, and claimed in general that the benefits outweigh the costs.

Most regulatory frameworks use the methodology of institutional regulation. This requires that different institutional categories in the market be defined, and the duties associated with each category be specified. If an institution falls within the definition of one category, it must register in that category, and undertake the associated duties. The institutional approach is based upon an assumption that there is a regulatory pyramid with well-defined participants at each level of the pyramid. The relevant participants are thought to be the government, regulatory commissions, exchanges, intermediaries and investors. New technology, however, has led to several fundamental problems with institutional approach. It has meant that there is ambiguity between different types of participants, most importantly between exchanges and brokers. This in turn has meant that different categories of market participants may obtain competitive advantages over their competitors via disparate regulation. A range of strategies have been developed to resolve this problem: define an intermediate category of market participant between an exchange and a broker; attempt to institute functional regulation; change the definition of an exchange; or separate the operation of an SRO from that of a market.

There are many different types of information about price and quote data that may be released to a market. Transparency in a market typically refers to the situation where details of prices and volumes of trades and quotes are publicly disseminated. Mandatory transparency may lead to the following benefits: investor protection, competition between brokers, fairness, informational efficiency, liquidity, integrity, and investor confidence. There are, however, also costs associated with mandatory transparency. Most importantly, private participants normally have an incentive to develop the best level of transparency. There may be trade-offs between regulatory goals, and the mandatory imposition of transparency may compromise some regulatory goals. There is in addition great uncertainty and ignorance about the effects of transparency. Dr. Lee argued that a key preliminary goal in emerging markets should be to effect transparency in the markets. It was, however, also necessary to recognise the costs of such a policy.

Various models were discussed for the appropriate allocation of international regulatory costs, duties and powers. These included national treatment, international harmonisation, identical international standards, having a lead regulator, having a supra-national regulatory authority, and finally, allowing regulatory competition and arbitrage. The problems with attempting to establish international harmonisation were examined. In particular, the effects of international agreements may differ from their creators' intentions: they may be used as a way of increasing protectionism, even when their stated goal is to liberalise markets.

Dr. Lee concluded with four general recommendations. First, understand the private incentives faced by market participants. Second, accept the merits of inter-market competition. Third, realise that judgment is required to balance the goals and tools available to a regulator. Finally, establish due process and transparency in a regulatory framework.

Ms. Randee Pavalow, Ontario Securities Commission, Canada, examined the issue of "Supervisory Techniques for Markets". Four broad topics were discussed with the aim of identifying and discussing the elements of effective regulatory oversight of the markets: the core objectives and principles of regulation, a framework for oversight, the allocation of regulatory responsibilities, and various new developments that were providing challenges for the regulation of exchanges.

The core objectives of regulation, as identified by IOSCO, should be the protection of investors, ensuring the markets are fair, efficient, and transparent, and the reduction of systemic risk. IOSCO also specified a range of more detailed principles implementing these objectives. Ms. Pavalow noted that in order to construct a framework for market oversight, it was necessary to identify the objectives of regulation, to establish mechanisms to deliver these objectives, to monitor their achievement, and to take enforcement or other corrective actions if necessary. Two types of markets were identified: traditional organised markets and new alternative trading systems. Amongst the factors, it was necessary to consider when determining appropriate regulatory techniques the nature of a market and its participants, the degree of the market's integration with other markets, internationalization, the impact of technology, market structure, and the powers and authority granted to a regulator by the relevant law.

Ms. Pavalow described various mechanisms that a regulator had at its disposal to achieve the desired objectives: licensing of markets; developing standards, requirements or rules; approval of rules or operational changes; monitoring through reporting, inspections and auditing; and enforcement. Licensing required that market operators should receive authorization from the regulator before engaging in the business. Appropriate conditions included the obligation to set rules and policies concerning many activities, such as the prevention of fraud, the promotion of the public interest, and the treatment of all participants in a fair and consistent manner. The development of standards should address the business conduct of market intermediaries, equitable principles for trading, and financial integrity. Monitoring might include a market surveillance program, examinations of business operations, and regular and exceptional reporting. A variety of enforcement strategies were identified, including censure, monetary sanctions, remedial measures, limitations on activities, special reporting, suspensions of licenses, and judicial orders and other legal remedies.

When examining the allocation of regulatory responsibilities, Ms. Pavalow commented that market regulation can be shared among different regulatory organisations, and that there was a continuum from a “pure market authority” which would essentially be a self-regulatory organisation, to a pure government regulator model. She also noted that one of the principles put forward by IOSCO was that the government regulator should make appropriate use of SROs. Three new developments that were providing challenges for the supervision of markets were examined: the establishment of alternative trading systems, the demutualisation of exchanges, and the deconstruction, unbundling and re-bundling of services provided by exchanges.

Mr. John Whitmore, Financial Services Authority, United Kingdom, examined the topic of “Screen Based Trading Systems” (SBTS). He noted that in the UK there were six exchanges, one of which was fully electronic, while all the others were either considering moving, or were already moving, towards using electronic trading systems. In the US derivatives markets, none of the exchanges were fully electronic, although some had been developing automated trading systems. Amongst the reasons for using an electronic system were that it was cheap, it increased access to the market allowing broad democratisation for the markets, and it allowed longer trading hours. It was noted that there was debate about whether automation enhanced liquidity, increased trading volume, and exacerbated volatility.

Mr. Whitmore remarked that IOSCO had initially developed some standards for automated trading systems in 1990, in response to the Chicago Mercantile Exchange

(CME)/Reuters GLOBEX electronic trading system. GLOBEX was intended to allow CME products to be bought and sold internationally on automated trading screens, and to let foreign products be traded on US terminals. Regulators were concerned that GLOBEX might become some form of monopolistic exchange, and wanted to create some transparent standards for assessing this and other questions. The intention was to create some non-exclusive principles, and to recognise that differences in the laws, powers, and customs, in different markets, might mean that not all the principles could be applied in every jurisdiction. The basic assumption was that automation did not change the goals of regulators, but that there might be some issues unique to automated trading systems that regulators had not already examined. Amongst the key issues examined were: Do electronic trading systems provide reliable, fair and orderly markets? Do they provide fair access? Can a trading platform place itself in other jurisdictions?

Given the passage of time since 1990 and developments in the markets, IOSCO decided that the original standards might need to be reformed, and so Working Party 2 of IOSCO undertook a survey of existing SBTSs, and existing regulatory structures governing such systems. The broad key regulatory issues remained the same, namely the nature of the trading platform, access to the platform, and access by the platform to different jurisdictions. The following specific issues were also examined: transparency, order execution, fairness on the technical side, system integrity, access, risk exposures, surveillance, disclosure, market operator's responsibilities, client order routing, and the allocation of international regulatory responsibilities.

Ms. Andrea Corcoran, Commodity Futures Trading Commission, United States, discussed IOSCO's work on the issue of "Information Sharing between Regulators". She noted that originally arrangements to effect such sharing had been directed towards enforcement issues, to be used typically after the fact of some regulatory violation. Recent examination of information sharing had focused, in contrast, on the inter-jurisdictional implications of "market events", given that information-sharing arrangements had not always worked well in the context of surveillance-related activities. Three definitions of a market event were provided: first, a financial crisis in a firm in one country that could affect other jurisdictions; second, unanticipated market moves, as a result of fundamental demand or supply factors; and finally, unusual price movements related to other financial products.

When a market event occurred international regulatory co-operation and sharing of information was normally valuable in order to supervise or manage customers' positions, or clearing arrangements in multiple jurisdictions. The main justification for such sharing was to isolate a problem, and to stop it from getting bigger. Furthermore, it was hoped that information-sharing would lead to more measured responses by regulators than they would undertake without such sharing. Forbearance requires having information, and for this reason market participants might wish not to discourage such sharing. The main types of information that might be shared as a result of a market event were be the size of the problem, the likely exposure of different participants, liquidity facilities available to markets and market participants, the existence of off-setting positions, and the identification of what were the risks associated with a problem and who would face them. Reciprocity was not thought a necessary condition for a regulator to help another regulator.

Mr. Sadakazu Osaki, Senior Analyst, Capital Market Research Group, Nomura Research Institute and Japan Securities Dealers Association, examined four broad issues related to the Internet and securities regulation: the effect of the Internet on securities markets, IOSCO initiatives on the Internet, the structure of the IOSCO Task Force report on the Internet, and various regulatory issues relating to the Internet. A range of effects of the Internet on the financial and futures markets were noted. Although the first Internet broker was established in 1995, by 1999 its use had grown enormously so that there were 7 million online brokerage accounts and upwards of 300,000 Internet transactions per day in the US, and there were 23 securities brokers with Internet transaction facilities and about 40,000 online accounts in Japan. Anybody could advertise on the Internet to solicit investors. Cyber-exchanges now allowed private investors to put orders directly onto an exchange.

Two IOSCO initiatives on the Internet were noted: a report on enforcement published in September/1997, and the report by the Internet Task Force of IOSCO published in September/1998. The Task Force Report was composed of four sections. Part 1 summarised the general characteristics of the Internet to distinguish it from traditional communication media. Part 2 described current Internet use by market participants and markets such as stock exchanges. Part 3 reviewed current regulatory responses to Internet issues, together with the use of the Internet by regulators themselves. Part 4 set forth recommendations and guidelines for securities regulators.

Mr. Osaki discussed various regulatory issues concerning the use of the Internet. Some existing regulations need to be re-examined, for example those concerning requirements for the submission of paper documentation, and the possibility of effecting private placements over the internet. New issues imposed by the Internet included various cross-border issues, and also some enforcement questions, such as investor protection in cyber-space and cross-border cooperation.

Mr. Masayuki Tamagawa, Director for International Affairs, Financial System Planning Bureau, Ministry of Finance, Japan, discussed briefly the work undertaken by Working Party 2 of the Technical Committee of IOSCO. He noted in particular its work on securities lending, and on the Y2K problem.

Mr. Hans Blommestein, Head, Financial Affairs Division, Directorate for Financial Fiscal and Enterprise Affairs, OECD, talked about "The Recent Extraordinary Changes in the Global Financial Landscape". He characterised the new financial landscape as being increasingly complex because of many factors: the pace of financial innovation, the amount of cross-border transactions, the rapidity with which shocks are transmitted, the sensitivity of markets to events, the multi-layered nature of financial intermediation, and the ability of the system to reward innovation enormously while at the same time to punish mistakes extremely harshly. Various crises were seen as the initiators of the new financial landscape: the Mexican peso crisis in 1994/95, the European exchange rate mechanism crisis of 1992, the South-East Asian crisis, the Russian crisis, and the LTCM crisis.

Mr. Blommestein stressed that while there was a great deal we still did not know about crises, some elements of their causes had become apparent. These included the increased volatility in markets, the greater level of competition, the importance of the exchange rate regime (with fixed-rate regimes coming under stress), and weaknesses in banking sectors (which constrained policy-makers responses significantly in times of crisis).

Various responses to the instabilities of the new financial landscape were identified: the key role of standards in finance, the need for greater transparency both for investors and for supervisors, and the requirement for sound monetary and fiscal policies. Mr. Blommestein argued against the use of capital controls, believing that they tended to lead to costly distortions. He also dismissed the possibility of separating "good" long-term investment flows from "bad" short-term investment flows. Not only did foreign direct investment require short-term flows, financial engineering made it difficult to distinguish the two. He accepted that there was a need to study whether there was excessive leverage. While he argued that proper market pricing and private surveillance should be expected to do most of the job, there was also a need for regulatory intervention. The fact that the various risk models surrounding the LTCM crisis proved so inadequate showed this. Mr. Blommestein welcomed the international initiatives responding to these issues, including the various standards of banking supervision, the guidelines on the transparency of central banks, the codes for fiscal transparency, and the OECD's code on corporate governance.

Mr. Toshio Karigane, Senior Executive Advisor, Daiwa Institute of Research, Japan, and three of his colleagues, discussed the topic of "The Development of the Capital Markets in Asia". They examined first of all the impact of the international flow of funds on developing countries. They provided a historical overview of the problems associated with the international movement of capital, as evidenced in the oil crises in the 1970s, the cumulative debt problem in the 1980s, the Mexican currency crisis of 1994-5, and the Asian currency crisis. Various factors affecting the Asian crisis were identified. These included macroeconomic conditions, contagion allied with the so-called "emergency measures", inadequate foreign reserves, private sector over-borrowing, consumption booms and bubbles, fragile private-sector financial markets, immature market infrastructures, linkages of the relevant currencies to the dollar, and dependence on short-term funds and the way in which funds flowed.

Two broad lessons for the future were drawn concerning liberalisation and the need for financial and capital market development. The Asian crisis was said to have been brought about because countries liberalised capital transactions without sufficient market infrastructure in the form of adequate liquidity and surveillance. All a country needs to do if it wants to shut itself off from the influence of foreign capital is to ban capital and foreign exchange transactions. However, such a policy is only feasible when a country has the plans and confidence to enable it to manage its development without relying on foreign capital, something which is extremely difficult to do over the medium or long term. The notion of liberalisation was therefore not rejected. Nevertheless, while a market may have the ability to allocate funds rationally, the converse is also true. The solution proposed by Mr. Karigane was to enhance financial and capital markets. More specifically, markets should be equipped with the ability to attract quality foreign capital, and they should be subject to appropriate surveillance and monitoring.

An overview was provided of the national capital markets and the development and support policies in Thailand, Malaysia, Singapore, Indonesia, South Korea, Hong Kong and Vietnam.

Three significant benefits of portfolio investment in Asia were noted: it provides new investment and profit opportunities, it reduces risk through international diversification, and it contributes to Asian economic growth. A range of factors were said to be necessary to make investments in East Asia attractive to Japanese investors. There should be improved corporate disclosure, active secondary markets should be promoted, efforts should be made to improve bond creditworthiness, and finally regulation should be administered in a transparent and consistent manner.

Mr. Karigane listed six conditions that were needed to further improve East Asian capital markets: first, the establishment of a well-balanced industrialised structure, including the development of tertiary service industries; second, reconstruction of the financial system as a public good; third, greater reliance on long-term debt liabilities denominated in local currencies; fourth, the development of human resources; fifth, flexible policy administration; and finally, enhanced corporate disclosure requirements.

Six factors, noted by the Hong Kong,China Monetary Authority, were identified as being necessary for the development of an international financial centre - the “Three S’s and Three I’s”: stability in the monetary system, supervisory prudence, soundness of public finance, instruments, institutions, and infrastructure. Mr. Karigane argued that financial centres could be expected to contribute to the development of local economies, but at the same time, countries would need to increase their savings and enhance their domestic markets so that effective use could be made of these funds. The key issues that needed to be studied to further the circulation of funds to Asia were the re-activation of the Tokyo market, the internationalisation of the yen, enhancing offshore and domestic bond markets, and developing common infrastructure for the region (such as cross-listing and netting procedures).

Mr. Yasuyuki Fuchita, Senior Economist and Chief, Capital Market Research Group, Nomura Research Institute, discussed the topic of the "The Japanese Financial System: Charting a New Course". He firstly noted that there were three views about whether the course had changed with the Big Bang in Japan: yes; yes, but there remained significant problems with individual banks; and no, nothing had changed.

In the old course, all financial institutions were protected by the government, and all players were guided by the government. Similar institutions therefore tended to operate in a similar manner. While such a system appeared safe and orderly, and while the weaker institutions were protected by the government, there were risks with such protection. A vicious cycle arose in the financial sector. Many banks lent to real estate firms, so that real estate values rose. Companies held real estate, so their share values rose. Banks held companies shares as collateral, so banks were able to lend more money to real estate firms. Finally excess bank lending broke the property price bubble.

The new course was planned to be one of competition, with revitalised securities markets, and a recovering banking sector. The government adopted three policies following the crisis: the use of special public guarantees for corporate borrowings; measures to resolve the banking crisis including capital infusions, new management plans by banks, and a new bank examination manual; and finally, zero interest rates. Recognition of the "over-banking" problem lead to various solutions. There would be a rationalisation of the market structure, by mergers and acquisitions, and also a rationalisation of market conduct, via selection and concentration on key businesses.

Mr. Fuchita claimed that the securities markets were becoming progressively more important for several reasons. Loan and asset securitisation was becoming more popular. Corporations were depending more on securities financing rather than direct credits. There would be a massive issuance of government bonds. There might be demutualisation both of insurance companies and of stock exchanges.

Many changes had occurred in the securities markets. Brokerage commissions had been deregulated. Internet trading had begun. Off-exchange trading had been allowed. The trading floor of the Tokyo Stock Exchange might be abandoned. There would be new entrants into the securities business. Banks' securities subsidiaries would start equity business. The Securities Transaction Tax and the Exchange Tax would be abolished. There would be a large amount of government bonds issued. Various changes had also occurred in the corporate sector. There had been a change in bank behaviour, so that the terms of loans were being rationalised with a phasing out of cross-subsidies, and cross-shareholdings were being reduced. International accounting standards were being adopted. Corporate governance was being more closely scrutinised. Foreign shareholders were becoming more important.

Mr. Fuchita thought that the key question was will these changes be enough. There were various indications that they might not be. Many of the financial alliances were unlikely to be effective. Almost all the banks started selling investment trusts - and thus still acted uniformly without thinking about their profitability. Although securities firms were now allowed to set brokerage commissions by themselves, some of the small firms had asked the Japan Securities Dealers Association to establish a fixed schedule. It was questionable whether industrial competitiveness would be enhanced through the governmental committee and debt-equity swaps. Notwithstanding these problems, however, Mr. Fuchita believed that the changes would be enough to move the Japanese financial services industry to a new course in the 21st century.

Mr. Noritaka Akamatsu, Principal Financial Economist, Capital Markets Development Department, World Bank, examined the issue of “Secondary Market Regulation and Second Generation Issues for Emerging and Emerged Markets”. He characterised “emerged” markets as being equipped with six basic “building blocks”: 1) a reasonably comprehensive framework for regulation and supervision, 2) functioning organised trading markets and clearing and settlement mechanisms, 3) securities intermediaries with significant experience, 4) investors familiar with the basics of securities investment, 5) a growing number of issuers, and 6) a growing variety of instruments. “Emerging” markets had not obtained these blocks.

Mr. Akamatsu argued that despite the fact that many markets had now “emerged”, the Asian financial crisis had highlighted various weaknesses in their operations. He discussed five issues of critical importance for emerged markets: market architecture, self-regulation, regulatory enforcement, the development of bond markets, and prudential regulation, internal control and risk management by intermediaries. Typically an emerging or emerged market inherited or created a single organised trading market when it started. The advantages of such a market architecture were that it might enhance the commercial viability of the exchange by forced concentration, that it might further price discovery by avoiding market fragmentation, and that it might lead to more effective regulation and supervision. Concentration on a single exchange also had disadvantages, however. An exchange might seek to extract monopoly rents when commercial viability was no longer an issue, and this might result in a high-cost structure discouraging market development.

Three policies concerning market architecture need to be considered. Trading markets and clearing and settlement institutions must strive to enhance competitiveness and efficiency beyond operation effectiveness. Market regulation must be revised so as to promote an open and competitive market architecture, while avoiding market fragmentation and maintaining market integrity. Market institutions' ownership and governance systems need to be reviewed so as to ensure their commercial sensitivity, competitiveness and relevance in an increasingly open architecture.

Mr. Akamatsu argued that emerged markets are increasingly ready to benefit from self-regulation. This was because a securities industry with greater maturity tends to recognise the benefits of enhanced investor trust. In addition, a more mature securities industry generates incentives for well-established firms to try to distinguish themselves as having high standards. Finally, some emerging markets cannot afford not to have self-regulation given their size and diversity. The following issues concerning self-regulation might need to be addressed, however: there may be confusion about the roles of a regulatory authority and that of an organised market; there may be a separation between the agency authorised to issue licenses, and the agency required to supervise markets; an association of market participants may be both an SRO and a cartel; and finally, conflicts of interest in SROs might be unavoidable.

It was thought that bond markets need to be developed to provide alternative sources of financing for government and corporations, to finance the resolution of banking and finance companies difficulties, and to diversify systemic risk away from the banking system. In this context, the lack of a benchmark yield curve has significant effects, beyond merely implying that the pricing of domestic debt instruments is difficult. It also implies that marking to the market of positions is difficult, which in turn means that risk management mechanisms are difficult to establish. It may also lead to a lack of human resources able to handle treasury management. The importance of Delivery versus Payment (DVP) was stressed. At times of crisis, markets which operate on a blind basis without DVP may face difficulties, as traders are unsure about the credit-worthiness of their counterparts and therefore stop trading. Mr. Akamatsu remarked finally on the need for strengthened prudential regulation, internal control and risk management of securities intermediaries so as to enhance the systemic stability of the financial sector.

Mr. Larry Bergmann, Senior Associate Director, Division of Market Regulation, Securities and Exchange Commission, United States examined the "Current Status of Regulation in the United States and Related Issues". He addressed four key areas: online trading, alternative trading systems, the "order handling rules", and Year 2000 issues.

It was claimed that online trading has provided investors with many benefits, including lower costs and faster access to the securities markets. It had also, however, given rise to various regulatory concerns, three of which were discussed: best execution, systems capacity, fraud and market manipulation. In the US, the duty of best execution requires that a broker-dealer seek to obtain, for its customer orders, the most favourable terms reasonably available under the circumstances. This duty had raised a series of questions concerning the execution of online trading, such as: Do online customers expect to get the national best bid or offer, and no better? Are they aware that price improvements may be available depending on where their orders are routed? and, Should broker-dealers have to disclose this.

Online customers wanted immediate and uninterrupted access to their accounts and immediate trade execution. There had however been widespread customer complaints about access problems, and the SEC had issued various guidelines regarding systems capacity requirements for online brokers. Six areas of particular regulatory concern in the online context were noted: 1) the offer and sale of bogus securities, 2) market manipulations and micro-cap fraud, 3) online investment newsletters and fraudulent promotions, 4) unregistered offshore investment advisers and broker-dealers, 5) fraudulent spamming (i.e. junk emailing) about investment opportunities, and, lastly, 6) the circulation of negative information to benefit short sellers.

Mr. Bergmann noted that one of the effects of the technological revolution had been the growth of screen-based alternative trading systems (ATS). The market had, in large measure, benefited from the creative use of technology introduced by, and competition from, such systems. The SEC had been concerned, however, to integrate these new markets into the national market system, and to ensure that their benefits were made available to all investors. In order to do so, the SEC adopted in 12/1998 a new regulatory framework known as “Regulation ATS”, which permitted each ATS to make a business decision as to whether to register as a broker-dealer or as an exchange. The choice that a system made would determine its regulatory responsibilities. If a system chose to register as a broker-dealer, the existing broker-dealer framework would apply with some additions. If a system chose to register as an exchange, it would have to fulfil the exchange obligations. The SEC believed that this framework would maintain an innovative environment that would allow new markets to develop under the regulatory category that best fit their objectives, while at the same time maintaining fair and orderly markets, assisting in the formation of capital, and protecting investors.

The US national market system is based on the belief that fair and vigorous competition makes the best markets, that investors should be able to rely on published quotations and transaction prices for an accurate picture of the market, and that investors should not have to compete with their brokers for quality executions. In the early 1990s, concerns began to be raised about retail order handling practices that appeared to diminish competition based on price and prevented published prices from adequately reflecting true trading interest. These practices also raised concerns about whether customers had been receiving best execution of their orders. In response, the SEC amended its “quote rule”, and passed the “limit order display rule”. Together these “order handling” rules had been thought to guarantee to the public a more complete display of the buying and selling interest in a security. Mr. Bergmann noted that since their implementation, there had been a historic decline in spreads, volatility had declined, and the number of market makers per stock had increased.

The SEC has taken the Year 2000 problem extremely seriously. In 7/1998 it issued an interpretative release containing guidance for public companies, investment advisers, investment companies, and municipal securities issuers regarding their disclosure obligations about Year 2000 issues. Also in 7/1998 the SEC issued rules requiring broker-dealers and non-bank transfer agents to file reports with the Commission regarding their Year 2000 compliance. In 3/1999, the SEC proposed rules that, among other things, would require broker-dealers and non-bank transfer agents that cannot achieve Year 2000 compliance in a timely fashion to cease doing business before the Year 2000 rollover.

Mr. Jurgen Oberfrank, BAWe, Germany, discussed the topic of “Towards Pan-European Markets? Current Status of Market Regulation in Europe”. He focused on four broad areas: the European Union, the European markets, the European market regulation - namely the Directives, and finally national regulation and the case of Germany.

A variety of milestones in the history of the European Union were noted. The Treaty of Rome was agreed in 1957 as the basis for liberalisation and harmonisation. In 1985, the White Paper proposed 282 Directives to implement the Treaty of Rome. In 1987, the Single European Act was agreed with the aim of realising the Single Market at the beginning of 1993. In 1990, the first stage of Economic and Monetary Union (EMU) was agreed, concerning the convergence of the various national economies and the coordination of the central banks. In 1992, the Maastricht Treaty was agreed concerning EMU and also various aspects of political union. In 1993, the Single European Market came into effect. In 1994, the second stage of EMU was agreed, and in 1999 the third stage of EMU was agreed and the European Central Bank founded. European integration in the financial markets was proposed for various reasons: to increase competition and transparency, to decrease the cost of capital, to broaden the variety of financial products available, to improve the allocation of capital, to increase savings and investment, and to increase the potential for growth.

Two main principles were used to implement European financial integration. The first was mutual recognition of national regulation, and the recognition that national regulations were considered equivalent, even though some differences between them were accepted. The second was minimum harmonisation so as to avoid regulatory arbitrage, and to abolish visible and non-visible barriers.

Mr. Oberfrank characterised the European markets by presenting various statistics. On the cash side, there were 25 stock exchanges, 8 of which were in Germany, with about 11,500 listed companies, and a market capitalisation of about 8.5 trillion Deutschemarks (in comparison with a total US capitalisation of 26.3 trillion DM). Some of the major companies were cross-listed, and turnover was concentrated on only a few exchanges. On the futures side, there were 35 derivatives exchanges, with a turnover of 114.9 trillion US dollars. Turnover was again concentrated on a few exchanges, and also in a few instruments.

Seven Directives passed by the European Union concerning financial markets were identified and discussed: the Listings Particulars Directive 1980, the Major Shareholdings Directive 1988, the Public Offers Directive 1989, the Insider Dealing Directive 1989, the Investment Services Directive 1993 (ISD), the Capital Adequacy Directive 1993, and lastly the Investor Compensation Scheme Directive 1997. Two other Directives currently being discussed were also noted: the Takeover Directive, the aim of which was to protect minority shareholders, and to establish rules when to make a mandatory takeover bid, and the distant Selling Directive, the aim of which was to protect customers from inappropriate selling of securities provided by phone, fax, mail or email. Mr. Oberfrank also provided a summary of the German framework for regulating the financial markets.

Ms. Benedicte Doumayrou, Commission des Opérations de Bourse, France, discussed the dynamics of the European markets. She noted first of all that Europe was part of the global markets. There were several key determinants of the market structure in Europe: the possibility of using the internet, disintermediation, and the development of new products and services. Other major influences, excluding the Euro, included: the liberalisation of the European markets via EU legislation (for example the ISD puts an end to the monopoly of exchanges); the fact that remote membership was dissolving the links between members and exchanges; the pressure that participants other than broker-dealers were putting to have direct access to markets; and the demutualisation and commercialisation of exchanges.

Ms. Doumayrou noted the existence of two competing models in the market for new companies in Europe. The first was EASDAQ, a Belgian based dealer stock exchange, also regulated in Belgium, that allows for remote access by its members throughout Europe. The second was Euro NM, which was, in contrast, a network of national exchanges.

The Euro was anticipated to increase the size of the European markets by eliminating currency risk, by widening the investor base, and by encouraging greater reliance on direct rather than credit financing. It was thought likely to lead to the disappearance of several currency contracts in the derivatives market, and thus to competition between futures exchanges with an attendant reduction in transactions costs. One single yield curve in the Euro-zone was also evolving, and this was also leading to competition between derivative interest-rate products. There was likely to be a re-allocation from country to sector allocation strategies. The existence of multiple benchmarks meant that different industries had different weightings in different indices, leading to much portfolio trading. Issuers were thought likely to be able to raise capital more easily, as investors would focus on credit rather than country risk.

Mr. John Whitmore, Financial Services Authority, United Kingdom, discussed some issues for regulators in the context of European markets. As a starting point, he noted that Europe (almost) had a single currency, many securities markets, limited legal harmonisation, and many regulators. Possible market models included having national markets with remote members, having linked markets sharing products or platforms, or having a single pan-European market. In national markets, regulatory issues included gauging the quality of remote members (for example by undertaking due diligence concerning these participants), and regulatory competition and cooperation. When markets are linked, three aspects must be specified: the clarity and robustness of market arrangements, the allocation of regulatory responsibilities, and information sharing and cooperation. Pan-European markets come under the umbrella of the EU Directives, and are located in and regulated from one jurisdiction, even they touch on multiple jurisdictions worldwide.

Regulatory issues concern the general confidence in the market's regulation, control of remote members, the efficacy of settlement procedures, cross-border market abuse, information arrangements, listing and takeovers, derivatives, and different clearing arrangements. More general questions include: Should regulators shape market structure? Is a large exchange super-efficient or merely monopolistic? Is the concentration of risks in a single clearing and settlement institution appropriate? and, What happens to the "rump" or small markets when the large ones begin to dominate trading? Mr. Whitmore finally discussed the desirability and necessity of establishing a pan-European regulator, noting both the large legal obstacles against developing such an institution, and also the influence of the pace of general integration on its feasibility.

Professor Anthony Neoh, Professor at Peking University, Advisor to the China Securities Regulatory Commission, and former Chairman, Securities and Futures Commission, Hong Kong,China and Technical Committee, International Organisation of

Securities Commissions (IOSCO) discussed the nature and methods of regulation. He started off by discussing two important strands in the development of financial markets.

The first was the creation of money. Money was first created as a means of exchange. This is because, in the banking sector, paper money creates more money. A bank lends money on some term basis. The money then becomes multiplied, as there are time lags in the payment. Cash is no longer the most important element of money. What is most critical is the amount of money that can be used immediately to make payments (typically called M1). Professor Neoh maintained that securities regulators must look carefully at the monetary system, as securities markets are one part of an indivisible whole. Managing liquidity in the markets and in the banking sector is an essential element of the securities markets. Without doing this, it is impossible to think about securities markets. The banking, clearing, and settlement systems are vital as brokers rely on access to liquid money.

Professor Neoh argued that the allocation of long term credit by a banking system is inefficient. Bankers face pressure to lend out money, and never wish to see their clients default. They will generally allow as much leeway as possible in order to prevent defaults, and typically lend money to bankrupt clients in the hope of getting their money out first. Bankers do not police their loans well. There is a herd instinct at work. However, most countries still depend vitally on their banking sectors. Capital markets provide only a relatively small source of funds. A small group of people have a vested interest in allowing bad credits to continue. Things have to go very bad before a banker blows the whistle. In order to assess correctly whether to lend money, bankers typically need to assess the long-term viability of the borrower, of the project, and the ability of the banker to use the loan as collateral. Even disregarding the difficulties of making these assessments, many other assumptions of bankers are often wrong, including those related to the growth of the economy, the level of confidence in the economy, and the desire to spend in the economy. Relying on a banking system to make efficient allocations of capital is therefore extremely difficult. If you rely on only one system of financial intermediation, there is no other counterbalance, or source of early warning signals. One key lesson of the Asian crisis was therefore that there were not deep enough capital markets in the region.

The second important strand in the development of financial markets that Professor Neoh identified was that capital markets are nothing more than information. Once this is accepted, key questions concerning this information must be answered: How good is this information? How do you disseminate it? How do you assess it? and, Is its dissemination fair? Confidence is a vital issue, and manifests itself through the public asking government: What did you do to protect me? This political reality needs to be translated into a regulatory reality, and the concept of disclosure was developed in response to this demand. There are two key elements of disclosure: if you put down a fact, you must be truthful; and if you put down an opinion, you must have a basis for this opinion.

The US has a politically neutral system of regulation based on two key concepts. First, when you sell a financial instrument, you are selling information about the asset. Second, the government makes no judgment about what is a good or a bad investment. The enforcement machinery relies on practitioners. This is not easy to obtain, however. The process of due diligence is a central element of the methodology that allows the government not to take a view about the merits of an investment. Before there is a body of practitioners able to undertake such an activity, however, it is difficult for a government not to make judgments about investments. Only if there are legal practitioners, valuers, and accountants, all of whom have adequate standards of practice, can disclosure really work. Fairness is a political necessity: information must be available to everybody at the same time.

IOSCO debated whether the promotion of economic development should be a key principle of regulation. IOSCO decided rejected doing so, however, as it was believed too vague a concept which could make regulation politically non-neutral. There is sometimes a tension between economic development and disclosure. For example, if state-owned enterprises are inefficient it may be desirable to restrict competition to allow them to make money. However, inefficiency leads to a lack of confidence and is therefore undesirable. Capital markets should focus on long-term rather than short-term profits.

Professor Neoh concluded with various recommendations. He stated, first, that regulation should preferably be disclosure-based rather than merit-based. If, however, disclosure was impossible, the regulator should use expert committees to advise on merit-based regulation. Second, in order to achieve a regulatory structure in which people had confidence, it was necessary to establish independence, accountability and professionalism at the regulator. Third, it was essential that a regulator cultivated a wide constituency. Fourth, it was vital to educate people both to think for themselves and to understand their respective duties. Fifth, transparency in the regulatory process was critical both to gain credibility, and to obtain the wisdom of the market community.

In response to the question of how enormous is the task of building capital markets in Asia, Professor Neoh stated that in the People's Republic of China there was a window of ten years at most to do the job. Over the next 20 years, the proportion of old people was going to grow significantly. They will not, however, be able to rely on public resources to fund their pensions, and the only way therefore to fund them will be to have efficient capital markets that allowed for their savings to be invested.

Following Professor Neoh's presentation, brief comments on the current state of development in various of the participants' countries were then made. In particular, representatives from **Indonesia**, **Kazakhstan**, **Korea**, **Myanmar**, **Uzbekistan**, and **Vietnam**, summarised the present situations in their markets.

Mr. Masayuki Tamagawa, Director for International Affairs, Financial System Planning Bureau, Ministry of Finance, closed the seminar by thanking everybody for their contributions. He noted that the development of the capital markets in a country was complicated, that no single model existed for the best way of doing it, and that it was becoming much more important following the Asian financial crisis.