# FIFTH ROUND TABLE ON CAPITAL MARKET REFORM IN ASIA

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## Conflict of Interest and Market Confidence

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# 1. CONFLICTS OF INTEREST: A PERVASIVE PROBLEM IN CAPITAL MARKETS

**In Capital Markets….**

Highly Disaggregated Functions

Many Operations and Institutions Scrutinized By Market

Assets Continually Traded and Re-Priced

Wide Range of Risk Return/Preferences

Great Willingness to Innovate

**but….**

Capital Markets are vulnerable to conflicts of interest

Abuses can occur at many places during intermediation

Capital markets depend on confidence that market are functioning effectively

Disclosure must be adequate

***Capital Market regulation is more concerned with detection and punishment of wrongdoing than any other form of financial regulation***

# 2. CONTRAST WITH BANKS

## In Banking…

Depositors Marginally Concerned with Monitoring Activities of Bank

Limited Capability of Depositors to Monitor Final Uses of Funds

Monitoring Mainly inside the Bank

Assets with Limited Liquidity

Narrower Range of Risk/Return Preferences

Risk Averse

Limited Willingness to Innovate

***Capital markets can be more efficient in allocating resources, but investors must believe that markets are working fairly and transparently***

# 3. CONFLICTS OF INTEREST IN INVESTMENT

**Investors Must Solve Agency Problems**

- Corporate Sector (Issuers)
- Intermediaries (Investment Banks &Broker/Dealers)
- Information Providers (Investment Research & Rating Agencies)
- Institutional Investors

**Market Foundations**

- Laws
- Regulations
- Industry Practices
- Disclosure
- Market Pressure

# 4. THE OPTIMISTIC VIEW

In 1980-90s, Capital Markets Replace Banks In Intermediation

Reforms Resulted In:

- Alignment of Corporate Management and Shareholder Value
- Intermediaries Represent Investors and Force Greater Transparency on Corporate Sector
- Institutional Investors Represent Interests of Final Investors
- Institutionalization of Asset Holdings

"New Economy" Justification for High Equity Valuations

***Capital markets an effective vehicle for financing and monitoring corporate sector "Shareholder value" is increasingly the global norm***

***Post 1997 Recommendations to Asian countries: Make more use of capital market model of finance and governance***

# 5. POST-2000 REVELATIONS SHAKE CONFIDENCE IN CAPITAL MARKETS

- **Corporate Governance**
  - Management Could Manipulate Boards
  - Executive Remuneration not Linked to Results
  - False or Misleading Data
  - Auditors and Boards did not Exercise Oversight
- **Intermediaries**
  - Research supported Investment Banking
  - Conflicts of Interest between Commercial Banking and Investment Banking
- **Rating Agencies** followed rather than led markets
- **Institutional Investors** accepted deceptive information, did not demand reform

***Abuses often discovered by parties other than the securities regulators***
***How seriously will these revelations undermine confidence in the markets?***
***Most revelations surface in the USA: Are other countries any better?***

# 6. EFFORTS TO RESTORE CONFIDENCE

- Initially, corporate sector and financial industry minimize extent of abuses
- ***New rules or better enforcement of existing rules?***
- … ***but*** Growing pressure from press and political circles
- ***Eventually***, consensus in favor of deeper reform
- Multi faceted ongoing approach
  - Individual Firms
  - Industry Associations and SROs
  - Stock Exchanges
  - Legislation
  - Regulation
  - International action
- ***Two dangers: Overreaction and lack of international coordination***

# 7. PRIORITIES IN CORPORATE GOVERNANCE REFORM

- More Effective Oversight Bodies: Board and the Auditors
- Better Control over the Executive Remuneration Process
- More Accurate Disclosure
- Improved and Consistent Accounting and Audit Standards
- More Effective Monitoring by Institutional Investors
- Implementation and Enforcement

# 8. RESEARCH AND INVESTMENT BANKING

**The Underlying Problems**

- Most investors depend upon research provided by financial intermediaries
- Intermediaries engage in underwriting, investment and market analysis
- Investors realize investment banks have an optimistic bias
- Researchers’ recommendations support IPOs
- Researchers’ compensation tied to success of IPOs

***Researchers sometimes knowingly promoted low-quality IPOs***

# 9. GLOBAL EFFORTS TO ENHANCE INDEPENDENCE OF RESEARCH ANALYSTS

**USA**

- NASD Rules to Tighten Controls on "Spinning" IPOs
- SEC Regulation on Analyst Certification (February 2003)
- SEC Approves Changes to Rules Of NASD and NYSE on Conflicts of Interest (May 2003)
- "Global Settlement" April 2002

**United Kingdom**

- FSA: Discussion Paper (July 2002) Consultation Paper .Close of Comment Period (February 2003)

**Other National Initiatives**

- Germany, Australia., Italy, Japan, Singapore

**International Efforts**

- EU, IOSCO

# 10. REFORMS OF INVESTMENT RESEARCH: THE CONTENT

- Separation of Research and Banking Structures
- Separation of Compensation of Research from Investment Banking
- Prohibitions or Limitations on Analysts' Participation in Marketing IPO's
- Institutional Separation of information flows ("Chinese Walls")
- Prohibition on "Spinning" in IPOs
- Disclosure of Researchers' Interests in IPOs

# 11. RATING AGENCIES

- The Underlying Situation
  - Increasingly Involved in other Activities than Rating
  - Increasingly Involved in Structuring Deals
  - Use Of “Ratings Triggers”
  - Significant Official Recognition Of Agencies
- Allegations
  - Agencies Allegedly Respond to Market Conditions, Rather than Lead
  - Slow to Announce Rating Changes
- Paid by borrowers they rate
- Reform Efforts
- US Congress, SEC, IOSCO
- ***Few instances of outright malfeasance: Should they have been more vigilant?***

# 12. INSTITUTIONAL INVESTORS: COLLECTIVE INVESTMENT SCHEMES (CIS)

- Represent final owners of capital
- Individuals increasingly prefer institutional investment to direct investment
- Pooling of savings by many small investors
  - Opportunities in capital markets
  - Small investors cannot afford diversified portfolios
- Defined legal and governance structure
  - Special laws
  - Regulatory structures
  - Internal controls to resolve conflicts of interest
  - Disclosure
- Professional management
  - Transparent
  - Investment policy
  - Low cost execution

# 13. AGENCY DILEMMA

***CIS agency problems:***

***Large pools of assets under control of financial institutions investors with limited ability to monitor***

- How to assure that assets are managed on behalf of Investor?

  Asymmetry of Power and Information

  - Investors (Small ,Often unsophisticated, Dispersed )
  - Investment Manager/ Operator
    - ✓ Control of information
    - ✓ Sophisticated
    - ✓ Affiliated with other institutions
- Outright Abuse: Fraud/ Theft /Misrepresentation
- Conflict of Interest

# 14. POSSIBLE CONFLICTS OF INTEREST IN CIS

**Between Investment Manager and Investor**

- Excessive Risk or Caution
- Execution of Investment Mandate
- Inappropriate Size
- Fee Structures

**With Affiliated Financial Institutions**

- Allocation of Costs
- Excessive Trading (Churning)
- Use of Affiliated Intermediaries
- Support of Securities Underwritten By Affiliates

**With Affiliated Non-Financial Corporations**

- “Captive” Finance

# 15. CRITICISMS OF CIS INDUSTRY

**Long Standing**

- High Fees/Lack of transparency in fees and costs
- “Bunching” around indexes
- Excessive trading
- In effective use of voting rights in portfolio companies

**More recent**

- Failure to moderate excesses of pre-2000 boom
- Acceptance of weak governance procedures (e.g. board oversight or stricter disclosure)
- Excessive support of incumbent management
- Favoritism to larger clients
- Toleration of market timing and intra day trading
- Dilution of earnings of small investor

# 16. REFORM EFFORTS IN THE CIS SECTOR

CIS firms and industry associations

- Stricter internal procedures and Codes of Conduct

SEC

- Greater transparency regarding use of governance rights
- Stricter rules to prevent abuses

IOSCO Guidelines on the use of governance rights by CIS

OECD Guidelines for CIS Governance