

**Summary of Proceedings**

**of**

**Third Tokyo Seminar**

**On**

**Securities Market Regulation**

**3 – 14 April 2000**

**Tokyo**

1. The third Tokyo Seminar on Securities Market Regulations was held at the ADB Institute premises in Tokyo from 3 to 14 April 2000 with field visits to local stock exchanges and securities companies from 5 to 10 April 2000. The Seminar was again jointly sponsored by the Ministry of Finance, Japan, the ADB Institute and the OECD. It was attended by 30 senior market regulators from emerging markets, particularly those from Asia. The main purpose of the Seminar was to disseminate knowledge and information to assist participants in developing a better understanding of the basic principles for the building of a fair and efficient securities market. Last year, the program was focussed on improving monitoring and supervision of the secondary securities market. This year, the Seminar was designed to cover regulatory issues relating to recent developments in securities market such as cross-border securities trading, online securities and demutualization of exchanges.

2. During the opening ceremony, **Dr. Masaru Yoshitomi, Dean, ADB Institute**, reminded the participants that although many economies in the region have recovered to a considerable extent, the causes of the recent financial crisis have not vanished with the recovery. Many countries continue to face daunting problems with non-performing loans, poor corporate governance, inadequate regulations and monitoring of the financial sector. He said that it would be unrealistic to expect that the region would be able to solve its problems of bad corporate debt, bank restructuring and inadequate bankruptcy laws relatively quickly. Many countries have still a long way to go before they could complete their structural reforms. Meanwhile, with the quickening of the pace of globalization of the world economy, countries in the region not only have to contend with having to solve their home grown problems of inadequate supervision of financial institutions but also with problems that will come from outside as well such as what had caused the financial crisis when countries in the region started borrowing short from abroad and lending long to investments that generate revenues only in local currency, leading to the twin problems of currency and maturity mismatches.

3. Some countries in the region were seriously affected by the crisis largely as a result of their lack of institutional capacity to regulate and monitor the performance of the financial markets. The markets have often been many steps ahead of the regulators and unless the regulators' skills match those of the market players, it is difficult to discipline them to ensure that they will not cause widespread disruption to the markets. Yoshitomi stressed that building capacity in the region and training personnel to better comprehend the complexities of the world's financial system is one of the important first steps to help region avert another crisis. The Seminar is held for this purpose.

4. **Mr. Masayuki Tamagawa, Director of the Research Office, Financial System Planning Bureau, Ministry of Finance, Japan**, spoke on the recent developments on the financial markets in Japan. He gave an overview of the changes occurring in Japan's financial markets. He noted three major points, namely, first, the restructuring of the banking sector in the 1990s which was sparked by the bursting of the bubble economy, second, the implementation of the Big Bang reforms, which center on the liberalization and reform of the securities markets, and third, the accompanying revision of the structure of government administration of the financial markets.

5. **Mr. Yuichiro Tamaki, Deputy Director, Market Division, Financial System Planning Bureau, Ministry of Finance, Japan**, started his presentation on the regulation in the on-line environment by explaining that one of the main amendments made to the Securities and Exchange Law was on the demutualization of securities exchanges. He had given an account of the background of Japan's financial Big Bang reforms relating to domestic developments such as the advent of Nasdaq Japan and Mothers (Market of High Growth and Emerging Stocks) at the Tokyo Stock Exchange, and trends in overseas exchanges such as those in New York and London. Regarding demutualization of securities exchanges, he also explained in detail about how to protect public interests and about the rules for securities exchanges to list their own stocks in their own markets.

6. **Mr. Yoshiyuki Komiya, Deputy Director, Office for Disclosure Systems, Financial Planning Bureau, Ministry of Finance, Japan**, addressed recent developments in the Japanese disclosure systems for corporate financial information, and accounting and auditing standards. His explanation focused on the following five aspects: (i) financial system reforms and corporate accounting, (ii) accounting system reforms, (iii) strengthening of auditing practices, (iv) recent changes to disclosure systems for electric filing, and (v) harmonization with international standards.

7. **Mr. Yasumasa Tahara, Deputy Director, Investment Service Office, Financial System Planning Bureau, Ministry of Finance, Japan**, gave a presentation on investor protection fund and separate management of assets of customers. He explained about the appropriate enforcement of segregated custody of customer assets, and investor protection funds in the connection with financial system reforms in Japan. Regarding the investor protection funds, he explained the purpose of its establishment, its background, and provided details on the system including the specific roles and practicalities of its operation.

8. **Mr. Jun Mizuguchi, Deputy Director, Securities Business Supervisory Division, Supervisory Department, Financial Supervisory Agency, Japan**, discussed the functions of supervisory authority and the main features of the recent securities business supervision, while touching on the connection with changes in the organization of the Financial Supervisory Agency (FSA), the basic policy and issues of the FSA, and recent trends in the securities business in Japan and abroad.

9. The Role of the Securities and Exchange Surveillance Commission was covered by **Mr. Masao Yahara, Deputy Director, Investigation Division, Securities and Exchange Surveillance Commission, Japan**. He discussed the Securities and Exchange Surveillance Commission - focusing on its organization, its functions, and its future challenges. When discussing its functions, he gave detailed explanations of countermeasures against such crimes as loss compensation and insider trading as well as inspection and market surveillance.

10. **Dr. Raj Chhikara, Senior Capacity Building Specialist, ADB Institute** gave a presentation on "Capital Markets and Corporate Governance in Asia: A Review of Recent Developments and Issues". He covered the following issues in his presentation:

- (i) Current status of financial and corporate governance systems in selected Asian countries,
- (ii) How the crisis affected these systems?,
- (iii) Necessary policy actions to strengthen the financial and corporate governance systems,
- (iv) Review of progress made after the crisis, what steps have been taken in response to the crisis,
- (v) What is needed further?, and
- (vi) Some regulatory implications.

11. His presentation first covered the capital market development issues and then the corporate governance issues in Asia. On Capital Markets Development, Chhikara first identified the main issues in Asia as follows: (i) many Asian countries witnessed significant growth in their stock markets in the early 1990s with significant increases in the market capitalization/GDP ratio from 1990 to 1995; the stock markets plunged during the crisis, but recently they have recovered significantly, (ii) the financial systems in the region are mostly bank-dominated with financing by bank loans relatively more important than capital markets, (iii) the Asian bond markets are underdeveloped, and (iv) both stock and bond markets are characterized by low levels of liquidity.

12. Next, Chhikara provided a brief comparison of the bank-based and the market-based system, emphasizing more dispersed ownership of debt and equity, higher liquidity of markets and stronger legal enforcement of contracts prevailing in the market-based systems.

13. As to which system is more appropriate for Asia, he argued that Asia needs to maintain and develop both systems to reduce overall financial risk through diversification and to utilize the symbiotic relationship between banks and the capital markets.

14. He explained that three steps are needed to be taken to develop the capital markets, namely, (i) a solid institutional investor base, including contractual savings institutions, (ii) a sustainable demand for funds with housing and infrastructure finance markets being important, and (iii) a supporting institutional framework through a strengthened system for payments, supervision, registration, information, custody, clearing and settlement.

15. He stated that systemic failure in the corporate sector during the crisis stemmed from: (i) weak legal and regulatory systems, (ii) inconsistent accounting and auditing standards, (iii) poor banking practices, (iv) thin and unregulated capital markets, (v) ineffective oversight by corporate boards of directors, and (vi) little regard for the rights of the minority shareholders.

16. Chhikara began his presentation on corporate governance by explaining that the agency problem constitutes the conceptual underpinnings of corporate governance. To solve this problem, the shareholders (principals) have to take steps to make sure that the managers (agents) work in their interest to maximize the value of the firm. In its simplest form, corporate governance is a solution to this agency problem.

17. He noted several analytical gaps in the current state of knowledge about corporate governance, (i) not all stakeholders (employees, customers, suppliers, communities) are included in the formal analysis of corporate governance, (ii) the analysis mostly focuses on corporations, and other major forms of economic organizations such as family businesses, worker cooperatives, state-owned firms and not-for-profit enterprises have been largely ignored, and (iii) corporate governance studies mostly focus on the industrialized countries and neglect developing and transition economies.

18. He described several ways in which corporate governance of firms can be strengthened: (i) board of directors - there must be a balanced mix of insiders and outsiders, and also some directors must be independent from the management, (ii) executive compensation – this must be tied to performance or price of the stock (executive stock options plans), (iii) the market for corporate control - mergers and acquisitions, hostile takeovers, etc. (iv) concentrated ownership, (v) monitoring by financial institutions, (vi) debt as a disciplining device – but it might work the opposite way in the presence of implicit guarantees as in the case of Asia, and (vii) product market competition.

19. On the alternative systems of corporate governance, Chhikara discussed three distinct types of corporate governance systems, namely, the market-based or arm's-length system (Anglo-Saxon), the relationship-based system (German-Japanese) and the family-based system. He went on to elaborate in some detail on the relative strengths and weaknesses of these alternative systems.

20. He mentioned that major reforms in corporate governance in the Asian countries after the crisis include: (i) changes in ownership structure – many countries in the region have eliminated ceilings on foreign equity ownership, (ii) shareholder participation and protection - most countries have taken steps towards strengthening the board of directors with increase in the number of independent members, improving the role of the annual general meetings so that all shareholders can have access, and strengthening the minority shareholder rights and protection with greater transparency, improved accounting and auditing standards, financial reporting systems and disclosure requirements, (iii) facilitating

a market for corporate control and fostering market competition, and (iv) credit monitoring and protection – strengthened bankruptcy procedures.

21. In the open discussion, one participant asked about the most appropriate corporate governance model for the emerging economies, assuming that there is no divergence among the countries in the APEC region. Chhikara responded by stating that corporate governance cannot be enforced overnight, and a gradual approach is needed. He did not favor any strict prescription in favor of any model, but stated that whichever model the country adopts, it should enforce transparency, disclosure and accountability and this was the responsibility of the regulators. Any economic system which is not based on the rule of law and is based on arbitrary relationships is not likely to be sustainable in the long run, because it would not be well-grounded. It seems to him that a system based on transparency, disclosure and rule of law is more resilient. It can cope with crises better.

22. On another question relating to whether countries in fact have any real choice in the selection of a particular corporate governance model since after all corporate governance is not something that can be enforced overnight, Chhikara agreed with the participant that no one model of corporate governance system can be enforced on a country overnight. His advice was that countries should first concentrate on improving their existing system. If it is a bank-based system, the emphasis should be on making it healthier and more accountable. On the other hand, there is need to have a more diversified financial system as he had mentioned earlier when he spoke on the capital markets. It is true that developing the capital markets would take a long time. However, in the global economy, it is not prudent to rely on one system exclusively as the recent Asian crisis has so amply demonstrated.

23. In the session on the respective roles of ADB and ADB Institute in developing the financial sector in Asia, **Dr. R. B. Adhikari, Senior Capacity Building Specialist, ADB Institute**, gave a succinct introduction to the basic mandate and strategic objectives of the ADB. He focused his presentation on the ADB's motivation for financial sector development in the region, its financial sector operations and achievements, and selected examples of ADB's support to financial sector development in the region. Adhikari also explained the objectives and scope of the ADB's operations in the financial sector, which includes banking sector reforms, capital markets development, covering domestic bond markets, pension funds, and newly-introduced guarantee operations. He said that the motivation for the financial sector development was premised on the belief that financial sector development makes domestic savings available for investment, reduces dependency on external capital, enhances more efficient capital allocation and contributes to higher growth, increased employment and sustained earnings. The ADB's strategy for developing the financial sector focuses on ensuring appropriate macroeconomic environment; policy, market and legal reforms; and strengthening institutional capacity. ADB believes in a tailor-made approach, taking into account country-specific factors and the stages of economic development of developing countries, and progressing step-by-step from the most basic requirements to the more sophisticated elements of well-functioning capital markets. While speaking on guarantee operations, he explained that the guarantees are partial but they are for 'credit' as well as for 'risk'. Partial credit risk guarantees are for gaining wider market access and for improving terms and conditions of private financing, whilst partial risk guarantees are for private sector to promote public-private partnership projects. These could cover risks associated with a portion of debt service on commercial borrowings and sovereign risks in private sector projects. However, these will require counter government guarantee and ADB's participation in the project.

24. Speaking on the role of ADB Institute, Adhikari said that it was an international development think-tank established by the ADB in 1997. It undertakes research in post-crisis development paradigms for Asia and organizes capacity-building and training activities in the same area to ensure sound management of development activities in the region. He added that very recently the ADB Institute has started the Asian Policy Forum, which is a

forum of regional think-tanks to research and make policy recommendations on developmental issues, e.g., the first theme was on how to avoid a similar financial crisis in the region. He also highlighted the work carried out and the support made by ADB and ADB Institute during the management of the Asian crisis. He stressed that efficient and transparent operations of governments as well as private financial and regulatory institutions are required to reduce systemic risks and promote investor confidence. A sound and efficient financial sector is the basis for an optimal allocation of freely moving capital for the benefit of all. ADB and ADB Institute will continue to assist countries in the region by providing financial resources, policy advice and capacity-building opportunities.

**25. Professor Anthony Neoh, Peking University, Chief 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 realities of regulating markets. Using the example of what happened in the markets in Hong Kong, China in 1997 and 1998 he drew some general lessons for how the regulation of securities markets needs to be undertaken in practice rather than merely thought about in theory.

26. The two periods were argued as being quite distinct. The Hong Kong, China market in 1997 was characterised as one with a range of attributes many of which were signalling the presence of an asset price bubble. These included first the fact that while trading in the stocks in the Hang Seng Index (the largest stocks in the Hong Kong, China market) normally comprised about 60 percent of the market volume, by January 1997 trading volume in non-Hang Seng index stocks was greater than in the Hang Seng index stocks. The non-Hang Seng stocks were significantly more volatile than the larger index component stocks. A second signal was that the amount of unfounded rumours about stocks in the market appeared to be very large - as indicated in the financial press. A third signal was that the presence of retail traders in the market appeared to be significantly greater than in the past. A fourth signal was the likelihood that a large amount of the trading in the market was being conducted on margin, sometimes on a four or five times leveraged basis. It also appeared that much of this margin trading was being effected through finance companies rather than through standard securities market accounts, and therefore that such margin trading was not under the jurisdiction of the securities market regulator. It therefore seemed likely that many brokers might not have sufficient regulatory capital to protect their customers in the event of a major market downturn.

27. In the presence of all the above signals, the Hong Kong, China regulatory commission undertook a wide range of activities to reduce the potentially adverse effects of the bubble bursting. It established guidelines for the "Red Chip" (the Chinese Government majority-owned) companies in order to ensure that they provided appropriate disclosure. It suspended the shares of those companies which persistently flouted the disclosure rules and which did not confirm or deny market rumours. It sought to enhance plain language disclosure. It strengthened its market surveillance procedures, and reinforced enforcement resources. It conducted a series of inspections of finance companies in order to assess the extent to which they were complying with margin requirements, and it started developing proposals for finance company regulation.

28. Quoting the IMF from its 1998 world economic outlook, Professor Neoh drew a central lesson from this period, namely that a key task for policymakers is to identify weaknesses and imbalances early enough to be able to address them before crises erupt. In such a context, the development and monitoring of early warning indicators of vulnerability may be helpful. In order to identify the potential weaknesses in a market environment, Professor Neoh maintained it is critical to understand the practicalities of how the markets work, rather than merely the theory of how they are supposed to work. Such an understanding requires constant vigilance over, and liaison with, market participants. It is critical to know who are the largest players in the stock and other related markets, which are the most volatile stocks, and which are the most margined firms.

29. The second period of regulatory activity that Professor Neoh examined was in 1998 when the Hong Kong, China authorities intervened in the securities and futures market in order to protect the integrity of the markets, and to stop the double play of speculators who were reportedly trading both against the Hong Kong, China dollar, and against the Hang Seng Index. He described the activities of the authorities in taking large positions both in the cash and the futures markets. While Professor Neoh noted that the authorities were exempt from the law against manipulation if they acted against the public interest, they were not above the law, and had therefore to follow all other aspects of it.

30. A key lesson that Professor Neoh drew from this period was that securities regulators need to stand firm against government as well as market participants in order to uphold what they believed to be the law. In this context, he stressed the benefits of all market participants being able to seek judicial review of the actions of a financial market regulator or of a government. From the regulator's point of view, he maintained that such suits should always be welcome. If the regulator was proved right in a suit, then it obtained independent verification of the legality of its actions. If it was proved wrong, then it had the opportunity to change its actions so as to promote the public interest.

31. **Mr. Hans Blommestein, Head, Financial Affairs Division, Directorate for Financial Fiscal and Enterprise Affairs, OECD**, talked on the topic of "Electronic Trading Systems in Fixed Income Securities Markets in Emerging Market Economies". The first part of his presentation contained an overview of electronic trading. He identified various types of Electronic Trading Systems (ETS), including dealer-based ones, matching systems, competitive bidding and auction systems. Three types of primary market systems were discussed: competitive bidding systems (issuer to dealers), online selling systems (dealer to clients), and direct primary issuance systems (issuer to clients). Two types of secondary trading systems were identified: single and multiple (co-mingled) dealer systems (to clients), and cross-matching systems (between dealers and client to client).

32. Blommestein noted that this was an extremely fast-moving area in which it was not clear which business model would succeed. He noted that the number and types of fixed-income ETSs were growing rapidly, quoting a survey from the US Bond Market Association that there were 11 such systems in 1997, 26 in 1998, and 39 in 1999. The growth of e-commerce revenues was also thought likely to grow enormously - Blommestein quoted a prediction of Forrester Research that it would reach US\$200 billion by 2005. He believed that markets and governments had to adapt to this new reality. In particular, Blommestein discussed the creation of MTS in Italy, an automated trading system for government fixed income securities and Euro-MTS for trading other European fixed-income government securities. He argued that ETS could have a potentially significant market impact by improving the transparency, liquidity and efficiency of markets. They will attract trading activity and a wider range of investors. Higher transaction volumes may in turn reduce dealer-spreads and issuer costs. Their impact will be affected by the actions of governments, dealers and investors.

33. Several driving forces for the greater use of ETS were identified. The first is technological change. This is forcing globalisation of the markets, and allowing the creation of new cheaper communications networks. It is enhancing pricing and security, and also making the transfer of information cheaper and more timely. A second driving force is transparency. Previously fixed-income markets were not highly transparent as dealers preferred having privileged access to information. ETS improve access to information, reduce information asymmetries, and allow market-wide integration of real-time trading information. A third important driving force is cost-reduction. ETS cut resource costs of all parties - sales, trading and back-office. They are most attractive in commoditised securities markets such as those for government bonds. Access can be offered at minimal costs.

34. Blommestein identified a range of policy issues arising from the development of fixed-income ETS. The first concerned the question of transparency. He noted that the

fragmentation risk in equity markets had led to mandated transparency across ETSs in these markets. However, he stressed that forced transparency in thinly-traded debt markets was opposed by dealers, as they argued that it could reduce their willingness to provide liquidity by forcing them to take lower risk profiles. Transparency could in contrast also improve dealers' pricing of risk and thus willingness to trade, and improve the attractiveness of the marketplace for less well-informed traders, such as retail investors. Transparency was not a major concern in foreign exchange markets.

35. The second policy issue discussed that arose from the development of fixed-income ETS was its effect on intermediation. Although the existence of ETSs reduced the advantages that dealers faced, Blommestein argued that this was not a major concern and that dealers would adapt. Furthermore investors would be unwilling to forgo dealer provision of liquidity. The major dealers were competing for supremacy in the ETS market. The third policy issue arising from the developing of ETSs was that of exchange demutualisation. Initiatives for demutualisation often begin with the conversion from traditional to automated execution technology. For those enterprises without a history of non-automated technology, the mutual structure was often avoided in favour of a for-profit, joint-stock company.

36. Blommestein drew a range of conclusions from his analysis. The advance of ETS is inevitable and will reshape the fixed income markets. They could improve national markets by extending access to, and awareness of, the markets. Two risks were that emerging markets could be left behind, and that major dealers could dominate them. While transparency is critical, and will naturally improve, it may need formal support. Intermediation will also remain important as ETS are not a substitute for committed dealers. Governments can champion ETS or they can leave it to the market. Primary dealers need to be involved. When choosing a system, issues to consider include participation, market-making obligations, vendors, and international alliances. Lastly, there will be regulatory concerns about transparency and access, member and market rules, and market soundness, namely the reduction of systemic and credit risks.

37. **Dr. Ruben Lee, Director, Oxford Finance Group, UK**, examined the topic of "Securities Regulation in Emerging Markets: Basic Issues and Current Concerns". He discussed seven broad topics. The first concerned the nature of regulation. The standard view of how regulation operates was described as being composed of four parts: an identification of regulatory objectives, a specification of the regulatory tools available, a judgement as to which tools could best deliver the desired objectives, and finally the implementation and enforcement of the chosen regulatory tools. This model was shown to have several problems - the inherent ambiguity of the standard regulatory objectives, conflicts between many of the goals normally chosen, and the likelihood that the available tools would lead to conflicts in the delivery of the chosen goals.

38. Other views of regulation were also described. These included seeing regulation as a continuous dialectic with a regulator setting rules, market participants reacting to these rules, and the regulator reacting in turn to their reactions. Regulation could be viewed as a political process, and an attempt to reconcile the interests of competing market constituencies. Finally regulation could be seen as promoting the interests of the regulators.

39. The second topic Lee examined was the allocation of regulatory powers. The key issue is how should the power to regulate financial markets be allocated between a ministry of finance, a regulatory agency or commission which is independent of government but still a public body, and one or more self-regulatory organisations (SROs). Many benefits of self-regulation were identified. It can allow good monitoring of markets beyond the reach of law. Practitioners are likely to want market integrity, Self-regulation can take advantage of practitioners' knowledge and experience. Practitioners can learn about regulation by participating in it. SROs can normally pay better wages than statutory authorities. Self-regulation can bring legitimacy. Self-regulatory policies may be less susceptible to political whim than those of statutory authorities. The alternatives to self-regulation may not be cost effective. And finally, self-regulation may be more flexible and informal than a statutory

regulatory process. The costs of self-regulation were also discussed, including the fact that the membership of SROs may further their own, and not the public, interests, leading typically to fraud or anti-competitive behaviour; that SROs may supervise their competitors; and that the existence of multiple SROs may bring regulatory gaps or antagonism.

40. Five ways of mitigating the costs of self-regulation were discussed: transparency in an SRO's decision making process, due process and the possibility of appealing SRO decisions, a diversity of representation on the board of an SRO, regulatory oversight of SRO decisions, and finally the minimisation of conflicts of interest by directors and employees of SROs.

41. The third topic Lee analysed was that of automation. Six broad implications of automation were identified: the possibility of constructing new types of trading systems; the probability that commercial enterprises will compete selectively with the different functions historically offered by exchanges; the fact that trading can now be undertaken without person-to-person contact; the ease and cheapness of entering the market for markets; the increased power of the buy-side; and lastly the democratisation of access to the trading environment. Lee then discussed one particular problem arising from automation, namely how regulatory structures need to be adapted to take account of new trading systems. The traditional model of institutional regulation was described, and then a range of shortcomings with this model in the new automated environment were identified. Finally, a series of alternative regulatory strategies were described and assessed. These included defining a new regulatory category for the new types of trading systems, moving to a functional regulatory approach, changing the definition of an exchange, extending the limited volume approach used in the USA, and finally following a policy of separating the self-regulatory functions from those of managing a market, and using competition policy to determine appropriate regulatory policies in regulating the behaviour of markets.

42. The fourth topic Lee examined was that of the governance of exchanges. He presented a simple model of how both non-profit cooperative exchanges and for-profit exchanges work. The two different governance structures were then shown to lead to the imposition of different costs on market participants in different environments. Lee argued that the mutual structure was appropriate in an environment in which exchanges operated as monopolies, because it allowed the owners of an exchange, the intermediaries, to stop the exchange charging anti-competitive prices for its services. In contrast, in an environment with competing markets the mutual status was shown to be relatively costly compared to the for-profit structure. Lee noted however, that the differences between non-profit cooperative exchanges and for-profit exchanges were more apparent than real. He maintained that perceptions of the so-called "successes" of exchanges de-mutualising should be treated with caution as they may simply reflect undesirable monopolistic activity.

43. The fifth topic Lee discussed was competition. He examined the difficulties of defining competition, and the associated concept of fragmentation, in securities markets. He defined a trading system as a mechanism that delivers three functions: information dissemination of prices and quotes, order routing, and order execution, and then identified a range of different meanings of fragmentation, relating to different ways in which the provision and operation of trading systems were consolidated or split. The costs and benefits associated with fragmentation were discussed, and on balance a judgment was made that fragmentation enhances market performance.

44. The sixth topic Lee analysed was that of information. He noted that there were a large number of types of price and quote information that a market could disseminate. The merits and costs of requiring transparency, namely full publication of prices and quotes, were then analysed. The benefits include enhanced investor protection, greater competition between investors and trading systems, enhanced fairness, improved informational efficiency, greater liquidity, better market integrity, and improved investor confidence. The costs of mandated transparency noted by Lee were that it interferes with private incentives to disseminate the optimal amount of information, that it ignores the inescapable trade-offs

between different regulatory goals, that it can give rise to regulatory inconsistencies and enforcement problems, and finally that it can lead to unpredictable outcomes, given that nobody really knows what the effects of transparency in different contexts are.

45. The last topic Lee commented on concerned various international regulatory issues. He noted that there were a range of different models that could be employed in the international allocation of regulatory duties, costs, and powers. These include national treatment, international harmonisation, identical international standards, the adoption of a "lead regulator" approach, the establishment of a supra-national regulatory authority, and finally regulatory competition and arbitration. The costs of establishing international laws and regulations governing securities markets were stressed, including particularly the likelihood that they will promote protectionism, often paradoxically in the name of investor protection and the promotion of systemic stability.

46. **Mr. Giovanni Sabatini, Head of Market Regulation, Commissione Nazionale per le Società e la Borsa, Italy**, discussed the topic of "New Market Structures and Regulatory Issues". He examined five broad topics. The first was the changing environment in securities markets, and measures to assess the quality of a market. A range of factors were noted as determining the new landscape in securities markets: securitisation and the leading role of markets in intermediating flows of funds, technological development, the end of exchange monopolies, demutualisation and the privatisation of traditional exchanges, and the end of geographical barriers. Seven aspects of a market were seen as critical in assessing its quality: liquidity, immediacy, transparency, price discovery, transaction costs, fairness, and the integrity of the market place.

47. The second topic Sabatini discussed was consolidation and fragmentation. A consolidated market was defined as one in which all orders flow to a single location for execution. In contrast, in a fragmented market orders are dispersed away from a single market. Several trends were identified as causing fragmentation: the presence of different geographical locations in which trading occurs, legal and regulatory barriers, the existence of different clearing and settlement mechanisms, the needs of heterogeneous investors, and finally technology. Sabatini argued fragmentation had several negative effects: decreased liquidity, increased costs of providing immediacy, reduced transparency, impaired efficiency and effectiveness of the price discovery process, higher transactions costs, and impaired integrity of the market place.

48. The third topic examined was the existence and implications of alternative trading systems (ATS). He noted several definitions of an alternative trading system. The first, created by Ruben Lee, is the MONSTER, the Market Oriented New System for Terrifying Exchanges and Regulators. Another more formal definition that Sabatini tentatively proposed is that an ATS is a system, other than a regulated market, that according to the rules set by the system operator brings together buying and selling interest in a way that forms, or results in, an irrevocable contract. ATS can be classified by the nature of their controlling party, by the types of functions they perform, by the financial instruments they trade, and by the type of price discovery mechanism employed.

49. A range of potential benefits of ATS were identified. They offer a broader execution choice via continuous auctions, limit order books, crossing and profile order market models. They may offer lower costs, and also commission and narrower spreads. They may allow anonymous dealing with the attendant benefits of a reduced market impact of large trades. They may trade unlisted securities. They may provide efficient execution and processing, and immediate price and transaction confirmation. They may offer extended trading hours, smaller "tick-sizes" (minimal price change), which enable more precise limit orders, and higher liquidity in certain securities through specialisation. They may promote arbitrage among different exchanges.

50. The fourth topic Sabatini examined was a series of issues faced by exchanges. He noted that many exchanges had demutualised or were in the process of doing so. Various

forms of consolidation were discussed, including joint ventures, mergers, contractual arrangements, and other deals (for example concerning clearing and settlement mechanisms). The merits of remote membership were also identified. It might make more instruments accessible to larger pools of liquidity, it might enable investors to deploy their savings internationally more easily, it might give intermediaries the opportunity to enhance their operating efficiency, it might give the operators of trading platforms greater opportunity to increase volumes and achieve economies of scale, and it might open the trading process to more vigorous competition and innovation.

51. The last topic Sabatini analysed were how the regulators should respond to the various issues arising in the new landscape for securities markets. He maintained that regulators should welcome financial innovation and greater efficiency. Nevertheless, they need to ensure that regulation remains appropriate, for example that it removes unnecessary barriers to entry and exit from markets and products, and that it ensures a level playing field. The economic impact of regulation needs to be considered, and regulation needs to be modified to account of new risks. Sabatini discussed a range of regulatory responses being undertaken concerning the three broad issues of ATS, the blurring of market roles, and transnational markets.

52. The key regulatory issues necessary to be considered in the context of ATS were market integrity, investor protection, and the reduction of systemic risk. Sabatini noted that European law seemed not to form a basis for distinguishing between exchanges and ATSS. Partly because there was no standardised approach to the role of ATSS, the subject had been identified by the European Commission as a topic for discussion in considering possible changes to the Investment Services Directive (ISD). A working group of experts from FESCO (the European association of securities market regulators) had convened to make and consult on proposals on ATS; to adapt existing regulatory approaches to ATSS and, if necessary, to suggest amendments to the ISD so as to enable it to take better account of likely developments in ATSS in order to support the delivery of the EU's Action Plan for Financial Services.

53. The blurring of market roles was noted as exchanges become more like brokers - in their legal structure, becoming "for profit" organisations, and in the functions they undertake – and at the same time, brokers become more like exchanges - looking to capture both sides of a trade by developing new order routing systems. This blurring required an evaluation of potentially anti-competitive effects of existing regulation. In particular, should "for profit" exchanges retain regulatory functions (such as listing)? Three alternative regulatory approaches were identified: an institutional approach, a functional approach, or separation and competition. A range of responses to fragmentation were discussed, including relying on market forces (i.e. doing nothing), implementing a "best execution rule", consolidating market information, or promoting a "virtual" consolidated limit order book.

54. The key problems arising from transnational markets noted were that current market regulations were drawn up to address a pre-electronic world, and that national regulators were currently responsible for all aspects of the market process (both the market operator and member firms), but that there were potential jurisdictional "overlaps" and "underlaps" not addressed by current legal regulatory framework. In response, Sabatini argued that regulators should develop approaches that will allow them to discharge their individual regulatory responsibilities arising from the operation of the market operating in multiple jurisdictions, to ensure that between them they address any additional regulatory risks that arise from the cross-border nature of such markets, and to maximise the effectiveness of regulation while avoiding unnecessary costs.

55. **Mr. Noritaka Akamatsu, Principal Financial Economist, Financial Sector Development Department, World Bank**, discussed the topic of "Market Architecture, Information Technology, and Secondary Market Regulation". He identified a difference between those markets which can be characterised as "emerging" in that they are just beginning to establish capital markets, and those markets which can be characterised as

“emerged” in that they have already implemented the basic steps necessary for the establishment of a capital market, and have attained significant size and maturity. He identified six key building blocks for the creation of a capital market: .) a comprehensive regulatory and supervisory framework; .)organised trading markets and clearing and settlement mechanisms; securities intermediaries with significant experience; .)investors familiar with the basics of securities investment; .) a growing number of issuers; and 6) a variety of instruments.

56. Mr. Akamatsu maintained that the financial crisis in Asia highlighted several key lessons. First, prudential regulation, internal control and risk management of securities intermediaries need to be strengthened in order to enhance the systemic stability of the financial sector. Second, bond markets need to be developed to provide alternative sources of financing for government and corporations, and to diversify concentrated systemic risk away from the banking sector. Third, there is a need for more effective corporate governance, which in turn requires enhanced standards for disclosure, regulatory enforcement for investor protection, and further education of investors. Finally both the emerging and the emerged capital markets need to take full advantage of information technology, and to allow and encourage inter-market competition both domestically and internationally.

57. Akamatsu then focused on the key “second generation” problems facing both emerged and emerging markets arising from advances in IT, changes in market architecture, and the difficulties and benefits of self-regulation. He noted that inter-market competition was increasingly intensifying through the emergence of Electronic Communication Networks (ECNs), off-exchange trading, cross-listing, and extended trading hours. This competition was argued as forcing exchanges to reconsider opening up access and membership, and changing their ownership and governance structures. Advances in IT were allowing the creation of new markets for both retail and wholesale investors. There was increased demand from market participants to enhance the efficiency of clearing and settlement arrangements through consolidation and the establishment of central counterparties. Akamatsu identified a key effect of advanced IT as the elimination of simple intermediation or agency services – a central function delivered by many market participants.

58. Some important policy decisions for emerging and emerged markets arising from the effects of IT were examined. The benefits and costs of promoting a single organised trading market in a newly developing market were analysed. The benefits include the enhanced commercial viability of a market with forced concentration of orders, the potential for better price discovery with a single trading platform, the likelihood that fragmentation would be reduced, and the relative ease of effective regulation and supervision. The costs of concentrating orders on a single market include the possibility of having a monopolistic rent-seeking exchange, and the disincentives for innovation.

59. A second key policy decision is whether to allow organised clearing and settlement institutions to compete as business entities or to promote a single clearing and settlement institution as a public utility. Allowing competition would again give the relevant organisations the incentive to offer good services at low prices in order to attract business. However, operating a single clearing and settlement institution would stop the waste of having multiple providers, and may also reduce risks and capital and liquidity requirements for participating intermediaries by centralisation of the settlement process.

60. A final important policy issue Akamatsu examined was the issue of self-regulation. He noted that self-regulation can promote ethical standards for business conduct that are higher than regulatory requirements, can provide expertise regarding market operations and practice, can respond flexibly and in a timely manner to changing market conditions, and can encourage a market-oriented spirit in the securities industry. Akamatsu argued that the emerged markets are increasingly ready to benefit from self-regulation given that their market participants tend to recognise the benefits of enhanced investor trust, and that the

more established firms have an incentive to distinguish themselves as being of a high standard. He argued in addition that some emerging markets cannot afford not to have self-regulation due to their size and diversity.

61. A range of other issues concerning self-regulation were also discussed. There may be confusion about the regulatory/supervisory roles of an organised market and a regulatory authority. It may be possible to separate the roles of authorities on the one hand to authorise or license firms, and on the other hand to supervise them. There may be a duplication of supervisory activities in a monopolised market structure. SROs may face conflicts of interest. Demutualisation may reduce the incentives facing markets to practice proper self-regulation.

62. **Mr. Tadashi Endo, Senior Capital Markets Specialist, International Finance Corporation**, examined the topic of “Major and Minor Issuers in Corporate Debt Markets – A New Policy Framework”. He compared first of all the development of a corporate bond market with that of an equity market, arguing that they needed to follow different development processes, and that a corporate bond market needed more care and attention than an equity market. Endo noted the progressively important role of corporate bond markets in economic development, and that infrastructure projects, utilities, housing and long-term corporate investments are increasingly expected to be financed by corporate bond issuance.

63. The typical structure and nature of corporate bonds were compared with bank loans. Bonds are larger in size, have longer maturities, and have more inflexible repayment patterns than bank loans. They may make either fixed or floating rate interest payments, while bank loans employ floating rate notes for longer maturities. The all-in-cost of bond issuance is cheaper than bank loans, and can be very cheap if advantage is taken of market opportunities. The rating agencies analyse the creditworthiness of corporate debt, while banks undertake proprietary credit analysis for the loans they make. Bonds are unsecured while loans are secured. The use of the proceeds from bonds are unrestricted, while for loans are restricted. Bonds are readily transferable, but have limited liquidity except for a few major issuers. Bank loans are not transferable and have no liquidity.

64. Endo noted that in order to issue bonds, companies need to have sophisticated cash management skills in order to match their cash flows with their payment obligations. The development of corporate finance knowledge and skills on the part of issuers is therefore indispensable for the development of corporate bond markets. Five salient characteristics of corporate bond markets in developed countries were identified. The US market is by far the largest in the world. Non-US markets are dominated by issuance by financial institutions. For most issues, the secondary market is marginal. Institutional investors dominate the market. The development process starts with a significant accumulation of capital, followed by the development of a government debt market, followed in turn by the development of a corporate debt market.

65. Endo drew a series of tentative conclusions about the development of corporate bond markets using some simple correlations. He noted that equity markets are almost always larger than bond markets, and then inferred that the development of a corporate bond market is likely to be dependent on the development of an equity market. For all countries apart from Germany and the Czech republic, government bond markets are bigger than the national corporate bond markets. Endo then suggested that the development of a corporate bond market may be dependent on the development of a government bond market.

66. In developed markets, the larger is the bank loan market, the smaller is the corporate bond market. Endo conjectured that corporate bond markets may therefore act as substitutes for bank loan markets, and may help defuse stresses in the bank loan market. In developing markets, in contrast, there appears to be a strong correlation between the size of the bank loan market and the size of the corporate bond market.

67. In both developing and developed markets, there appears to be no correlation between the size of a country's GDP and the size of its equity market. Endo concluded therefore that a minimum size GDP was not necessary for the development of an equity market. In developed markets, there is a negative correlation between the relative size of the bank loan market and the country's GDP, again suggesting that the existence of a large bank loan market is not necessary for growth in GDP.

68. For both developing and developed markets, there is a marked correlation between the size of the government bond market and the size of a country's GDP. In developed markets, however, there is a much stronger correlation between the size of a country's corporate bond market and the size of its GDP, than there is in developing markets. Endo thought this might suggest that while a government bond market is necessary for a country whatever the size of its GDP, businessmen may be more fiscally disciplined than government officials.

69. Endo drew the following conclusions from this analysis for the policy implications for corporate bond market development. A certain level of financial market development, including most importantly the development of a government bond market, may be necessary for a corporate bond market to develop. It may therefore be appropriate to attempt to develop a corporate bond market not in the first round of development of a financial market, but in subsequent stages. Given that a corporate bond market may act as a partial substitute for a bank loan market, its development could be used to help restructure banking systems. Economic development geometrically increases the role of a corporate bond market, and therefore there may be an increasing risk of not developing such a market. The size of an economy matters for the development of its corporate bond market, and it may therefore be appropriate to seek economic unification to spur such development.

70. Endo drew a distinction between major and minor issuers in corporate bond markets which is vital to understand the functions of corporate debt markets, and to lay out a development strategy for debt markets. The "major" corporate issuers offer a regular, sizable and stable supply of bonds of high quality and uniform characteristics. Their issuance is typically on a cyclical basis and indifferent to market conditions, and therefore not opportunistic. They are typically bought by "impatient" traders with a high demand for immediacy. They meet basic investment needs across a country, are widely held in the market, and are relatively easy to buy and sell. The typical issuers are housing finance companies, infrastructure and utility companies, and development finance companies. In contrast, the "minor" issuers lack the characteristics of the major issuers. They may be highly creditworthy, but only offer irregular issuance for relatively small amounts. They are normally bought by patient traders with a lower demand for immediacy. The minor issuers are opportunistic in terms of their issuance strategies. There is a diverse range of characteristics of the bonds issued by the minor corporations. They are issued to meet specific, short-lived investment needs, and there are few or no trades in their issues after the initial placement. The major issuers typically constitute a small percentage of the total corporate bond issues.

71. Endo argued that the primary market for minor issuers plays an enormous role in supplying long-term funds to a country's private sector. Typically investors follow a buy-and-hold policy for minor issuers, have specific investment needs and therefore purchase only specific types of issuers. There is thus incessant competition both between issuers to take advantage of the specific needs of investors, and between investors to purchase the types of bonds that satisfy their specific requirements. Illiquidity never lessens the importance of a corporate bond market to minor issuers, as evidenced by the observation that of the 400,000 corporate debt issues outstanding in the US in 1996, only 4 percent of them were traded even once in the year.

72. With an efficient primary market, a corporate bond market can generally alleviate stresses on the banking system, help procure long-term debt capital for long-term investments, and enhance the efficient reallocation of capital. A key policy focus should

therefore be to deregulate aggressively the primary market for corporate debt. This involves first eliminating such statutory restrictions as product features, issuers' eligibility, underwriters' eligibility, and tax disincentives, and, second, creating necessary market infrastructures, including institutional investors, setting up a disclosure system rather than a merit-based approach to new issues, establishing a credit-rating system, promoting intermediaries and appropriate trading, clearing and settlement systems. It is in addition very useful to have appropriate pricing benchmarks for corporate debt. While these would standardly come from government bonds, if this is impossible it may be possible to develop "de facto" benchmark issues, which are alternative to benchmark issues of government bonds. These should be of the highest credit quality, with great transparency about the issuer, and have a simple and consistent basis for issuance.

73. A "de facto" benchmark issuer is most likely to be chosen from one of the "major issuers", namely the infrastructure and utility companies, housing finance companies, or development finance companies. Since "de facto" benchmark issues are corporate bonds and not free from default risk, the "de facto" issuer may need implicit forms of credit enhancement, in addition to its profitable business performance and financial position. Such implicit forms of credit enhancement have to be carefully designed and subject to a sun-set clause to avoid any moral hazard.