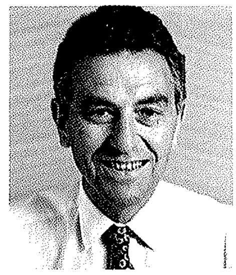
Regulation with a light touch



With the 1980s behind them, corporate regulators now have new and complex issues to consider, writes ***Charles Williams****. The nineties are a time of continuing revolution — and a modest approach to control.*

The two topics which come first to mind when people think of the ASC are the relative importance of criminal and civil proceedings and the impact of the Corporations Law on company directors.

However in this article I will not be focusing on the issues of the 1980s. Instead, the subject will be the major market issues of the 1990s from a regulator's perspective. I should add that while I look at these issues through a regulator's eyes, I do not believe that regulators will ultimately be the major influence on the outcomes in the 1990s, any more than regulators (or the lack of regulation) determined what happened in the 1980s. Market forces are most often more powerful than even the strongest governments, as recent events in the currency markets have shown.

Nevertheless, markets are now raising questions which demand regulator attention, just as much as they demand the attention of those who work in the markets and whose livelihood depends on market forces.

The forces of change

The changes which we are now seeing in the market are often attributed to *deregulation*. While policy-makers and regulators may find this proposition kind to their egos, I don't believe that the changing regulatory environment has been much more than a response to forces unleashed in the marketplace. The most important of these forces have been:

- the technological revolution in the storage, manipulation and communication of data;
- the greater volatility of interest rates and exchange rates in the 1980s;
- greater competition in financial markets;
- the explosion in the volume of cross-border financial flows.

These ballooning cross-border financial flows are illustrated in the following figures.

- International bank lending rose from $US324 billion in 1980 (4 per cent of OECD GDP) to $US7.5 trillion in 1990 (44 per cent).
- International bonds outstanding rose from $US259 billion in 1982 to $US1.65 trillion in 1991.
- US securities transactions between residential and non-residential counterparties increased from 3 per cent of GDP in 1970 to 9 per cent in 1980 and to 93 per cent in 1990.
- Turnover in foreign exchange rose from an estimated $US650 billion a day in April 1989 to a current $US900 billion.

These factors have produced a dy-

Charles M. Williams FSIA is deputy chairman of the Australian Securities Commission. This article is adapted from an address to the West Australian Division of the Securities Institute.

namic and self-sustaining process of change in the financial services industry. While change is at different stages across sectors and countries, nowhere does it show any signs of slackening. This change is manifested in various ways:

- Automated stockmarkets and trading systems — specifically, the *electronic bulletin board* which disseminates trading information from one or more markets to subscribers who conduct transactions independently in another market or by direct negotiation with a counterparty; the *order routing system* which channels orders to buy or sell to a market or dealer; and *communication* of orders and transformation of orders into trades.
- The explosion of derivatives trading, on organised markets such as futures and options exchanges and "over-the-counter" trading, or by dealers acting as principals. The global stock of options, futures and swaps rose from $1.1 trillion in 1986 to $6.9 trillion in 1991. The actual credit risk in the over-the-counter derivatives was $250 billion. The top 12 US banks' share of that risk accounted for $150 billion.
- The growth of index funds and basket trading, which cause individual stocks to be treated like commodities rather than units of ownership in a business.
- The declining significance of private direct investment and the growth of pooled investment via superannuation, unit trusts and other vehicles. There was a persistent decline in Australian household shareholdings in the first half of the 1980s. In 1989, direct holdings were estimated at less than 4 per cent of household-sector assets.
- The blurring of the line between savings and investment as a result of the breakdown in distinctions between different kinds of financial intermediaries.
- The increasing concentration of trading volume and market capitalisation of listed equities in a handful of large companies. At 30 June 1991, the 20 leading stocks on the Australian Stock Exchange represented 53 per cent of the market capitalisation. The top 50 represented 76 per cent of market capitalisation (out of a total 926 listed stocks). In the year to 30 June 1991, the 20 leading stocks on the ASX contributed to 63 per cent of the value of equity turnover. The top 53 contributed 83 per cent.

Consequences of change

No market participant has remained unaffected by the revolution I have outlined.

Australian stockbrokers are increasingly acting as principals rather than as agents. Estimates of the volume of principal trades range between 30 and 60 per cent, and even the lower of these figures represents a significant increase from the historical position.

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Markets such as the ASX are finding themselves increasingly in competition, both with other exchanges and with proprietary systems bringing buyers and dealers together.

Among listed securities there is an increasingly sharp distinction between the stocks in the select group traded by institutions and the rest. The ability of companies in the second tier to raise capital is more and more threatened by the high cost of compliance with prospectus laws and the thinness of their markets. The bottom 695 stocks listed on the ASX, constituting 8 per cent of market capitalisation, contributed only 4 per cent of market turnover in 1990/91.

Pooled investments are likewise subject to competitive pressures. As their operating costs increase, the drive for economies of scale grows, leading to greater emphasis on effective marketing and distribution.

Two further results of this pressure are a shrinkage in the number of managers and strategies to cut portfolio management costs through "passive" or index fund management techniques. Managers which pursue active strategies are using derivative-based techniques more and more.

For private clients and their advisers, investment choices are becoming more difficult and this is driving advisers to keep up by joining franchise operations which can supply the analytical services and other support required.

In many respects, these changes have been very beneficial. Transaction costs in the stockmarket are lower and commissions and fees for pooled investments have come down. Investors are getting a wider range of products to meet their particular circumstances and companies are able to satisfy their financing needs more precisely through specialist financial products and techniques. The result is better resource allocation in the economy than would have been the case a few years ago.

Nevertheless, financial regulators must balance these advantages against the need to protect the financial system, and in some cases investors themselves, against a widening range of financial risks.

Regulatory Issues

Prudential regulation

A financial market regulator such as the ASC is in a different situation from a banking regulator. The latter is concerned that depositors do not lose the money they have entrusted to a bank.

A securities commission has a more limited objective, which is broadly to allow investors freedom to make investment decisions for better or for worse, but to be protected from the consequences of defalcations or financial failure of their chosen intermediary, or of another market participant with which they do not have a direct relationship.

Since stockmarkets have the unfortunate ability to spread risk from one party to others, it is necessary for market mechanisms to have built-in protections against domino effects arising from failure of participants. These protections involve capital and liquidity standards.

However, these prudential requirements are pulling against the market pressures to which I referred earlier. Brokers are under pressure to make their capital go further, so as to accommodate more principal trading. Those who are active in the derivative markets are under constant pressure to come up with new products.

Where the derivatives concerned are traded, the markets seem to be increasingly volatile. Where they are not traded, dealers generally do not unwind positions but rather hedge them with other positions. More positions may in some circumstances increase risk. Chances are that complex strategies may be based on assumptions which are incorrect or inadequately understood.

In October 1987 portfolio insurance failed to provide adequate hedging for those with long equity positions. Today's derivative strategies are more sophisticated but the danger of failed hedging remains.

An article in the *Institutional Investor* of September 1992 discusses at length the risks in derivatives and points out that E. Gerald Corrigan, president of the New York Federal Reserve Bank and a key international banking regulator, has publicly warned US banks to "take a very, very hard look at off-balance-sheet activities" (in derivatives), concluding ominously: "I hope this sounds like a warning, because it is."

Felix Rohatyn, senior partner of the New York investment bank Lazard Freres, has complained that "26-year-olds with computers are creating financial hydrogen bombs".

In regulating market intermediaries, the regulators are therefore challenged to devise capital standards which take account of the new kinds of risk, often in the context of financial service groups which are undertaking a number of different activities.

Two elements in this situation make it particularly difficult to solve.

The first is that in many countries banks are heavily involved, even to the extent of being the main players in the securities markets: banking regulators' approach to determining what is an adequate amount of capital tends to be driven by their experience with credit risk.

The second is that securities regulators, because they come from varying cultures and have different historical experience, themselves tend to favour different ways of determining capital adequacy. Some of them, one suspects, are also under pressure to improve the competitive position of their markets in the international arena by setting lenient capital requirements for their domestic players.

This conflict between regulators has various international manifestations.

There are disagreements about both the method of calculating capital and the numbers used in the calculation. As well, there are two schools of thought about how to handle financial conglomerates. The bankers' approach is to have a single standard for adequate capital, applied to the group as a whole. The securities regulators, however, prefer each regulator — insurance, banking, securities or whatever — to apply its own standard to the relevant bit of the conglomerate, and keep in close touch with the others to ensure that the "firewalls" between them are not breached.

Clearance and settlement

Determining how much capital securities dealers should have is, of course, not the only agenda. Also of fundamental importance is being satisfied that the clearance and settlement systems used to complete deals are substantially risk-free. The influential Group of Thirty think-tank has stimulated worldwide attention to the need for settlement arrangements to be quick and certain.

In 1989 the National Companies and Securities Commission convened a high-level steering committee to break the log-jam impeding change to Australia's antiquated procedures. The first result was the FAST streamlined paper-based system which has enabled the ASX to achieve a T+5 settlement standard. Following this the ASX, funded by $35 million from the National Guarantee Fund, has set out to build the "dematerialised" CHESS system, complying fully with international standards for clearance and settlement.

Competition between markets

The competition between markets that is a feature of the 1990s is another area calling for regulator attention. Among the issues are:

- Should rival markets, or institutions wanting to trade direct, be permitted to "free-ride" on stock exchanges which perform regulatory services, such as compelling compliance with listing rules, and market surveillance programs? Laurie Cox, chairman of the ASX, recently put the cost of regulation to the exchange in 1991/92 at $13 million.
- Should market providers be allowed to "unbundle", ie, separate, the provision of regulatory services and the trading facility?
- Is there an economic disadvantage in allowing trade in a group of securities to be fragmented across several markets, or can we expect order-routing systems to pull the various markets together?
- Should a country be worried if markets in its major investment counters move offshore because of stamp-duty or other factors? Can it stop such moves? If the major stocks migrate, what will happen to the domestic market and will second-tier companies suffer a further rise in their cost of capital?

The answers to some of these questions are unclear and will probably be "on-balance" judgment calls in the end. One must remember that the Trade Practices Commission has a substantial influence in this area (although without responsibility for the markets of the kind borne by the ASC), and the Attorney-General, advised by his department, has the legal power to settle issues relating to the establishment of markets and the rules under which they operate.

Smaller companies — the cost of capital

As noted previously, the problem of the high cost of capital for smaller companies is partly related to the secondary market in their securities. But the cost of raising capital in the first place is probably a greater hurdle for those seeking to "go public". It is interesting that the US Securities and Exchange Commission has devised a detailed plan to make capital-raising easier for small companies. In Australia, where the political agenda is still dominated by the international credibility issues of the 1980s, such a step seems not to be feasible at the moment.

Some would question, in any case, whether mere regulatory action can overcome the two-tier market phenomenon if banks are nervous about lending to any but the most rock-solid of borrowers.

Pooled investments

The regulatory agenda relating to pooled investments is perhaps the most complex of all those I have raised. It covers many regulatory topics and policy issues, and the fortunes of many powerful players in the financial markets.

The regulatory topics include initial disclosure statements, their content and the liability for errors and omissions; standards of continuous disclosure; and mechanisms to induce proper care for investors' interests, either by self-regulation and checks and balances within the investment vehicle, or by government regulatory supervision and its power to punish.

The principal policy issue is the degree to which participants in collective investments should be seen to enjoy government protection, and it is therefore related to the third of the regulatory topics mentioned above. The issue takes its most acute form in relation to superannuation, but it is present wherever governments regulate investment/savings vehicles.

Generally speaking, the more strongly governments purport to "control" those vehicles, the greater the likelihood that taxpayers will be called on to make up deficiencies. The US Savings and Loan catastrophe and Victoria's Pyramid experience are recent examples. The dilemma (for political resolution) is that the taxpayers' contingent liability is proportionate to government's apparent regulatory power, not the resources which are in fact devoted to the task. No-one can guarantee that budgetary pressures, industry lobbying or some other factor will not cause regulatory effectiveness at some point to fall short of expectations.

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Under these circumstances, one might expect some reliance on checks and balances and on self-regulation to buttress the exercise of sovereign power. One hopes that Discussion Paper 53 on Collective Investment Schemes by the Law Reform Commission and the Companies and Securities Advisory Committee will be looked at in this light.

The fortunes of powerful market players are relevant in two ways.

The first is that even though, as I wrote at the beginning, regulation does not determine broad market trends, it does influence competitive outcomes. This was very clear in the days when financial institutions were regulated according to the type of institution, but it is only a little less true in the days of largely functional regulation. Because of this, regulatory proposals need to be carefully evaluated to see whether the net regulatory outcome can be justified by commercial advantage to the market as a whole or to a substantial part of it. Additionally, where the regulatory outcome and a commercial advantage could be achieved in several ways, the preferable way is the one which does least to tilt the playing field.

The second point to note is that powerful players will not be averse to at least the appearance of strong government regulatory intervention. Moral hazard, like some other transgressions, can be enjoyable for participants at the time: the consequences can be left to future managers and tomorrow's taxpayers. It is therefore not surprising that some financial institutions prefer government to private regulation.

I hope it is clear from this overview of regulatory issues in the securities markets area that there is no lack of issues for governments, legislators and the responsible agencies to tackle in the foreseeable future. The issues themselves are complex enough. But in addition there is a need to be highly selective in choosing appropriate ways to tackle them. Some modesty in the setting of objectives is called for, because it is far easier to promise than to deliver. ■