READJUSTING THE BALANCE IN MARKET SELF-REGULATION AND GOVERNMENT PRUDENTIAL CONTROL

SECURITIES INDUSTRY ACT 1986

Introduction

THE recent stock exchange crisis precipitated by the failure of Pan Electric Industries Limited ('Pan-El') exposed serious regulatory flaws in our existing system of securities market regulation. However, the Government was not caught unprepared as a draft amendment of the Securities Industry Act 1973[1] intended to tighten control of the stock market was already prepared before the advent of the crisis. These amendments are now found in the Securities Industry Act 1986[2] which repealed and replaced the 1973 Act, and came into force on 15 August 1986. It is interesting to note that in describing the Act in its draft form, the Government stated that it has "all the essential elements, necessary to strike a balance between prudential control and freedom of action".[3]

Before judging the Government's claim that the new Act has struck a proper balance between prudential control and self-regulation, it is useful to recapitulate the causes that led to the Pan-El debacle. An understanding of what these causes were would enable us to evaluate the effectiveness of the present scheme of regulation.

The Failure of Co-operative Regulation

The regulatory scheme existing at the time of the crisis relied upon the philosophy of self-regulation in the industry.[4] In this scheme, the Stock Exchange was managed by a five-man committee elected annually from Exchange members. The committee exercised self-regulation in that it was responsible for rules and by-laws governing the operation of the exchange. It administered the listing rules and also enforced the corporate disclosure policy. In the words of a commentator, "the Exchange is responsible for its day-to-day business and exerts an important front line supervision of the industry".[5]

Consistent with the philosophy of relying on the Stock Exchange to regulate itself the Government reserved to itself powers of basic administrative

1 No. 17 of 1973.

2 No. 15 of 1986.

3 See statements by the Finance Minister, Dr Richard Hu, in an interview with the Business Times, 24 December 1985.

4 Tan Pheng Theng, "The Securities Industry Bills of Malaysia And Singapore" [19731 1 M.L.J. XVI.

5 *Ibid.*

control, namely, approving the establishment of a stock exchange and its rules, and licensing dealers and investment advisers.[6]

To complete the description of the then existing regulatory system the role of the Securities Industry Council should be mentioned. The Council was set up by the Finance Minister under section 3 of the Securities Industry Act 1973 and is primarily an advisory and consultative body.

In December 1985, the Pan-El crisis exposed the regulatory gaps and weaknesses of the then-existing regulatory framework. In the scramble for business, brokers indulged in margin financing and credit extension practices which went well beyond normal limits of prudence. These malpractices only came to light when Pan-Electric Industries Limited, a publicly-listed company, defaulted on a S$7.5 million loan repayment, as a consequence of its having incurred estimated losses of S$40 million on forward contract deals with stockbroking firms. It also came to be known that out of the S$600 million estimated exposure on forward contracts of all stockbroking companies, S$40 million was tied up in deals with Pan-Electric Industries Ltd.[7] As the stockbroking firms concerned in these forward contracts with Pan-Electric Industries Limited were threatened with insolvency and likely to default on their contractual obligations, the Stock Exchange of Singapore suspended all trading from 2 to 4 December 1985.

The Monetary Authority of Singapore (M.A.S.) did not provide a ready statement to help to dispel the crisis atmosphere until later. In fact, in the course of the crisis there was even some public confusion as to whether the M.A.S. or the Ministry of Finance was responsible for the regulation of the Stock Exchange.[8] However, the M.A.S. did succeed in stablising the Exchange by ensuring that the stockbroking companies would not default on their obligations to investors and by ensuring that the banks did not withdraw credit lines to the brokers.

The root causes of the crisis could be summarised as follows:

(i) The mismanagement of a publicly-listed company which precipitated the crisis,
(ii) The failure of the Stock Exchange to regulate itself and to prevent over-trading in excess of capital funds by its members.[9]
(iii) The Government's failure to exercise external control and supervision.

The New Balance

In restrospect, it is fair to comment that the previous scheme of cooperative regulation between the Stock Exchange and the Government

6 See Tan Pheng Theng's review of Pillai's *Sourcebook of Singapore And Malaysian Company Law,* (1975) 17 Mal. L.R. 392, 395.

7 See P.M. Pilial, "The Singapore Securities Market: A Watershed In Regulation and Development", a paper presented at the 3rd Singapore Conference on International Business Law: "Current Developments in International Securities, Commodities and Financial Future Markets", 1– 3 September 1986, Singapore.

8 See statements of clarification by the Minister of Finance in Business Times, 24 December 1985. The confusion may in part by compounded by the fact that the Finance Minister is also the Chairman of the M.A.S. and the M.A.S. managing director, Mr J.Y. Pillay, is also the Permanent Secretary (Revenue) in the Ministry of Finance.

9 Statements by the Finance Minister, Dr Richard Hu in Parliament. See Singapore Parliamentary Debates, Vol. 46 No. 7, 10 January 1986 at Cols. 684-689.

failed because the scheme did not pinpoint responsibility clearly enough. The consequential pressure for public accountability on the part of regulatory authorities thus results in a diminution in scope for self-regulation and an increased role for government in the regulation of the securities industry. However, it would be pointless to enquire whether greater intervention by the Government under the Securities Industry Act 1986 spells the end of self-regulation. Self-regulation is but a formal concept. In the opinion of one writer, "... the formal position should not be confused with the underlying substance and in terms of substance self-regulation is a matter of degree".[10] In fact, the scheme under the new Act to a great extent continues the Government's attitude of reliance on self-regulation. But the new approach is that the Government now assumes a threatening posture and unless the Stock Exchange regulates its own behaviour in the desired way it will be subject to external control.[11] Despite the threatening posture, this continued partial reliance on self-regulation is consistent with the worldwide shift in public policy towards domestic financial market deregulation.[12]

The Control of Self-Regulation

Under the new Act, the government was established its threatening posture by reserving to itself certain reserve powers of intervention. In addition, the Act also requires market intermediaries[13] such as dealers, investment advisers and their respective representatives and member companies to observe further requirements of "business prudence and fair trading practices".

1. *The Government's Reserve Powers*

The threat of government regulation is a real one in view of the fact that the Act contains numerous provisions that allow the M.A.S. to intervene whenever it is necessary. The presence of these powers would ensure that the Stock Exchange Committee acts firmly and swiftly in the public interest at all times. In contrast, under the old Act the Government had no reserve powers of intervention that would enable it to regulate a securities market directly. The only requirements were that the establishment of a stock market required ministerial approval,[14] and that the Minister was to be notified of amendments to rules.[15] Under the new Act, section 21 effectively allows the M.A.S. to directly control the trading operations of a securities exchange. Section 22 allows the M.A.S. to prohibit trading in particular securities in order to protect persons buying or selling the securities, or in the interest of the public It is also of interest to note that under section 20, the M.A.S. as well as a securities exchange or an aggrieved person may apply to the

10 See Alan C. Page, "Self-Regulation: The Constitutional Dimension" (1986) 49 M.L.R. 141, 144.

11 This regulatory approach is similarly noted by a writer. See *ibid.,* at p. 149. This regulatory strategy has so far been effective in that the Stock Exchange of Singapore has formed an Inspectorate Department to closely monitor stockbroker accounts and operations. The formation of the Inspectorate is to enable the Stock Exchange to continue self-regulation as much as possible. See The Straits Times, 11 July 1986.

12 Report Of The Economic Committee, *The Singapore Economy: New Directions* (February 1986), p. 172.

13 Section 2 of the Securities Industry Act 1986 definies the various categories of market intermediaries.

14 See s.6 of the Securities Industry Act 1973.

15 *Ibid.,* s.7.

High Court for an order to compel observance or enforcement of rules or listing rules of a securities exchange. Section 11 also empowers the M.A.S. to apply to the High Court for an appropriate injunction or declaration where it appears that an offence in relation to dealing in securities has been committed or that the rules or listing rules have been infringed. Finally, we should also note that by virtue of section 19(3) and (4) the M.A.S. not only has a right to review disciplinary action taken by a securities exchange but it may also exercise direct disciplinary power if the securities exchange concerned has failed to set.

The threat of government regulation has so far seemed to work. The Stock Exchange has since formed an Inspectorate Department to closely monitor stockbroker accounts and operations. It is widely believed that the department was formed so that the Stock Exchange could continue to regulate itself as much as possible.[16]

2. *The Government's Powers of Direct Regulation*

In a move to inspire public confidence that the Stock Exchange's governing committee is motivated by public interest rather than the sectional interests of its members, the Government has appointed nominees to the Stock Exchange committee under the authority of section 16(3). Where previously the Government was only to be notified of amendments to stock exchange rules, section 18 now requires prior approval by the Government of all amendments to such rules. The section further provides that the Government may directly amend the rules. And as earlier mentioned, the M.A.S. also has powers to discipline a market intermediary directly.

Given these wide-ranging reserve and direct powers, it is important to point out that they could not be effectively exercised unless the M.A.S. is also able to maintain a close and active day-to-day surveillance of market conditions. The M.A.S. would also require information and investigatory powers.

3. *Powers to Require Information and Powers of Investigation*

By virtue of section 19, a securities exchange is now statutorily obliged to provide assistance mainly in furnishing information and returns to the M.A.S. in order that it may discharge its functions and duties. Section 5 now empowers the M.A.S. to require production of books and records from a wide range of parties involved in securities dealings.

Section 10 contains an extremely long the complicated provision the gist of which empowers the M.A.S. to extract information from anyone who might be in a position to supply the required information concerning any transaction in securities. Persons and organisations who are liable to supply information include the Stock Exchange, market intermediaries and directors and senior management staff of a concerned company and generally any person capable of giving information concerning any dealing in relevant securities. The information that may be required under the provision includes th identities and financial positions of relevant persons, and any information that might have affected a dealing.

Under section 11, the M.A.S. is given the power to conduct investigations where any fraud or offence against the Act or any other law with respect

[16] See The Straits Times, 11 July 1986.

to dealing in securities is suspected. Section 12 confers powers upon the M.A.S. to inspect under conditions of secrecy the records, etc. of a securities exchange, a dealer or an investment adviser. Finally, section 67 obliges a dealer or an investment adviser to furnish returns and provide information relating to his business to the M.A.S.

4. *The Requirements of Fair Trading Practices*

Under the previous Act certain restrictions were already imposed on the conduct of securities business by market intermediaries. Generally, the relevant provisions prohibited certain representations of their ability or qualifications, required disclosure of an interest in any communication concerning securities, and also required a dealer to disclose the fact when he is dealing as a principal.[17] Under Part VI of the new Act, new provisions were inserted to control market intermediaries in the conduct of their trading activities and to spell out minimum ethical standards. A notable provision is section 49 which contains requirements formerly found under Regulation 19 of the Securities Industry Regulations 1974. This "elevation" of the regulation into the main Act suggests the importance attached to the requirement that a dealer shall document sales and purchases of securities by issuing a contract note. The requirements have been expanded, as formerly a contract note was only required if the transaction was not a transaction entered into in the ordinary course of business between stockbrokers who were members of the Stock Exchange. Now contract notes, are required even if the transaction took place in the ordinary course of business at a securities exchange as long as the dealer is acting as an agent.

As for provisions designed to buttress ethical standards, section 50 of the new Act requires, whenever a market intermediary makes a recommendation with respect to securities that he disclose the nature of his interests in the acquisition and disposal of those securities. Section 51 provides that an adviser must not recommend a security unless he has adequate and reasonable factual basis for the recommendation. Otherwise, he may be liable to compensate the client for his loss. Finally, section 54 imposes criminal liability on a dealer who has failed to comply with a client's instructions to purchase or sell securities.

5. *The Requirements of Prudential Control*

As discussed earlier, the Pan-El affair revealed that in the scramble for business, dealers indulged in margin financing and credit extension practices which went well beyond normal limits of prudence. The stockbroking companies were also found to be under-capitalised and trading in excess of their capital funds.

One way to prevent the over-indulgence in margin financing would be the imposition of margin covers.[18] Although the Minister of Finance under the previous Act had powers to make rules with regard to margin cover, these powers were not exercised.[19] Under the new Act section 55 provides that the M.A.S. may similarly provide regulations for margin cover, which are now found in Regulation 24 of the Securities Industry Regulations 1986.[20]

17 See ss. 32, 33 and 34 of the Securities Industry Act 1973.

18 Margin requirements or covers are sums of money or prescribed securities deposited by clients with brokers for purchases on the broker's credit or funds.

19 See s. 96{l)(h) and 0) of the Securities Industry Act 1973.

The under-capitalisation of dealers has also necessitated the introduction of regulations containing capital maintenance rules. Under the old scheme, stockbroking companies were not subject to any capital maintenance rules except to those required by the Companies Act and common law. As it is beyond the scope of this paper to discuss the detailed working of the new rules, only their basic features will be mentioned. Regulation 17[21] requires dealers to maintain their aggregate indebtedness to below 1,200% of their adjusted net capital[22] and to ensure that the adjusted net capital is always above S$250,000. Regulation 18 prohibits the granting of unsecured advances or loans to directors of a member company which at any time exceed S$5,000. Regulation 20 places limits on a member company's debt-exposure to a single client, namely, it must not exceed 30% of its average adjusted net capital. Regulation 21 places limits on a member company's exposure on a simple security. Essentially, this means that the liabilities of a member company arising as a result of trading or underwriting activities connected with a single security are to be restricted.[23] Regulation 22 prohibits a member of a company from permitting its investment in securities to exceed 150% of its average adjusted net capital. Finally Regulation 23 requires member companies to maintain a reserve fund which is not available for distributions as dividends.

The Regulatory Role of The MAS.

The M.A.S. now has a comprehensive array of powers available to detect and check malpractices. The Finance Minister may claim that this represents a proper balance between freedom of action and government prudential control. Whether this balance will result in effective regulation is quite another matter. The M.A.S. may be handicapped in its task as a result of institutional constraints.[24] For instance, it may lack the time or staff to maintain effective market surveillance, to check through the returns filed and to carry out inspections. It may also not have professional staff with the depth of experience that will always enable them to identify an improper business practice. As noted by a writer:[25]

> "A capital market is not created and sustained merely by passing the necessary laws. It is contingent upon the expertise of securities, banking, legal, and accounting professionals and para-professionals and competent regulators."

For example, India also has a highly interventionist legislative framework for securities regulation. It has been said that the experience there has been a negative one. The reason is that "the Central Government of India has devoted very little manpower to the implementation of the Act".[26] As noted by the same commentator, these ineffectively-administered laws "are worse

20 Regulation 24(2) provides that a member company shall not permit the sum of margin and market value of securities bought or carried in a client's margin account to fall below 130% of the debit balance in that client's margin account.

21 Securities Industry Regulations 1986, S206/86.

22 For a definition of adjusted net capital see Regulation 17(5).

23 For definition of "exposure to simple security" see Regulation 21(2).

24 See Philip Pillai, "Securities Regulation in Malaysia: Emerging Norms of Government Regulation", (1986) 8 Journal of Comparative Business and Capital Market Law 39, 42.

25 *Ibid.*

26 See Robert C. Rosen, "The Myth of Self-Regulation Or The Dangers of Securities Regulation Without Administration: The Indian Experience" (1979) 2 Journal of Comparative Corporate Law and Securities Regulation, 261, 262.

than useless; they are dangerous because in creating an appearance of government control investors unjustifiably rely on them."[27]

In this regard, it is comforting to note that the Finance Minister announced in April 1986 that a new unit of the M.A.S., staffed with more specialists, has been set up and has been given the responsibility of administering the Securities Industry Act.[28]

Another cautionary note is that the identification of a malpractice may be fraught with conceptual difficulty. The difficulty is that in securities regulation the identification of a malpractice often involves legal, moral, social and economic questions. What may constitute a malpractice from the point of view of a lawyer may not be so in the view of an economist who is likely to adopt an analysis based upon cost and benefit. To confound the matter further, there is often a strong social inertia against any efforts to prohibit what was previously a legitimate trade practice. Investors at large as well as market professionals would probably resist any change to what they have always regarded as the rules of the game unless they have been collectively hurt by the abuses in a particular trade practice. For example, the current controversy regarding the practice of short-selling indicates a strong resistance to its being banned. Similarly, if not for the Pan-El crisis it would have been difficult for any regulatory body in Singapore to ban forward contracts without causing a public uproar.

Conclusion

The point that the writer is making is that the detection and identification of malpractices may be extremely difficult. Having identified a malpractice it may then be necessary to engage in a public relations exercise to change public opinion in favour of prohibiting what was previously regarded as a legitimate trade practice. Both these tasks are difficult to perform, but are essential if the M.A.S. is to discharge its responsibilities. The M.A.S. armed with wide administrative powers under the Act, should now begin to positively explore the new parameters of its administrative discretion.

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27 *Ibid.*

28 See The Straits Times, 1 April 1986.

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