

# Choice of Structure for Regulating Securities and Futures Markets



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## **Introduction**

I am honoured to have been asked to speak at this Conference and to be able to offer my thoughts on the development of an administrative structure for regulating securities and futures markets in China. Before doing so I would like to congratulate the State Council on its decision to establish a regulatory authority since it is important that those operating in the markets clearly understand that there is a regulator, who that regulator is and what that regulator does. I hope to share with China some of Hong Kong's experiences, both our successes and our mistakes, just as Hong Kong has shared in the diversity of experiences from other markets.

Of course Hong Kong's regulatory structure is only one amongst many systems which exist throughout the world. I think it is fair to say that the diversity of structures indicates that there is no unambiguous answer to the question of what is the most appropriate regulatory model for any particular country. If one goes behind the choices that have been made by various countries we tend to find that, more often than not, the establishment of a new regulatory authority is a response to a market crisis, and that the administrative system adopted for regulatory purposes is heavily influenced by domestic historical and political considerations.

This is certainly true of Hong Kong, which decided to establish its independent statutory market regulator, the Securities and Futures Commission (SFC), in the wake of the 1987 stock market crash. Hong Kong's decision to establish a regulator independent of government in the form of a corporation run by a board of directors was to a large extent a product of the failure of the administrative structure previously in existence to regulate the securities and futures markets. Although the main problem with Hong Kong's previous administrative structure was that it was understaffed and underfunded, the magnitude of the problems that surfaced in 1987 prompted Hong Kong to adopt a fresh approach. Likewise, in the United States, the Securities and Exchange Commission and the securities regulations which it administers were established during the early 1930s in the wake of a series of market abuses and malpractices throughout the 1920s.

China is truly fortunate not to be in such a dramatic and reactive situation.

In deciding on the most appropriate administrative structure for regulating the securities and futures markets in any particular country, I believe that there are a number of dimensions which have a significant influence on the final outcome. These include:

- domestic political and historical considerations, including the role of the central government *vis-à-vis* other tiers of government, especially provincial government;
- the nature and relative importance of the existing bodies which regulate financial services or other economic activities;
- the stage of development which has been reached by self-regulation and the extent to which government views self-regulation as a viable part of the system; and
- the geographic size of the country, which determines whether or not the regulatory authority has to establish regional offices.

The system of regulation which ultimately emerges will be the outcome of the interaction of these various dimensions. The process of choice is rarely a smooth one because there are usually conflicting

considerations and many of those involved in the decisions will have positions which they will wish to protect or expand.

As I mentioned a moment earlier, there is significant variation between the systems which have been established to regulate the world's securities markets. Having said this, most of them do seem to function fairly smoothly. So I am not here today to tell you what the best system is for China; only to discuss some of the factors that must be considered when choosing between the alternatives. However, I must emphasise that we should never forget the human factor. The performance of a regulatory authority depends not only on the administrative structure in which it functions but it also depends most importantly on the quality and the experience of the persons who work at the authority as well as the extent to which those persons are provided with adequate resources. It is most important that some of the staff have practical experience - you have a saying for this - "Talking to a scholar for a night is better than reading for ten years".

In deciding on the appropriate administrative structure for regulating the securities and futures markets in a particular country, at the very least it is necessary to address the following matters:

- The nature of the body or bodies who will undertake the regulation;
- The activities which are to be subject to regulation (which involves decisions about the classes of persons who will be regulated);
- The functions and powers which are to be given to the regulatory body; and
- The form in which the regulatory requirements are to be mandated.

These matters tend to be interactive or interdependent, although for illustrative purposes I will discuss each in turn. During the process I will refer to regulatory structures which have been established in various securities markets, with particular reference to Hong Kong, Singapore, Australia, Canada, the US and the UK.

*First, the nature of the body or bodies who will undertake the regulation.*

In making this decision there are a number of different models to choose from. As I mentioned earlier, in Hong Kong we have a regulatory body which is a corporation run by a board of directors and which is relatively independent of Government. Although this scenario has proved very workable for Hong Kong, and has the advantage of freeing the Government from the need to become directly involved in the controversial issues which arise during day-to-day regulation of the securities and futures markets, it does not mean that Government is totally removed from the regulatory process. For one thing, independent or quasi-government bodies cannot make legislation. In Hong Kong, a Government Department, the Monetary Affairs Branch, sponsors new legislation which is proposed by the SFC and which has to be put before the Legislative Council. The SFC is also dependent upon the Governor for the approval of its annual budget. Furthermore, before the Commission can use some of its significant supervisory powers, for example, to direct the exchanges and clearing houses to take certain action, we must first consult the Financial Secretary and receive his tacit approval - or at least a no objection. In the final resort the Governor is able to give directions to the SFC.

At the opposite end of the spectrum is the model under which a Government Department, such as a Ministry of Finance, regulates the securities and futures markets. This is the situation in Germany and Japan, although Japan has just made changes to these arrangements by injecting into its system certain elements from outside Government. On 20 July a Securities and Exchange Surveillance Commission was inaugurated within the Ministry of Finance with two main responsibilities - the investigation of unlawful conduct which might undermine the fairness of the market and the inspection of securities firms. The Commission is composed of a Chairman and two Commissioners appointed from outside the Ministry and there is an element of independence in that the Commission is not under the

direction or the supervision of the Ministry of Finance. This structure is a response to criticisms that Government has been too close to the day-to-day problems of the Japanese market.

Somewhere in between the two models mentioned above lies the approach adopted by many countries under which a "Securities Commission" is established with its own charter but usually subject to direction from a Minister. The staff tend to be career civil servants. This is the approach adopted by the (Federal) Governments in Australia, France, Italy, the Netherlands, New Zealand, Spain and the United States.

In Canada the Federal Government does not regulate the securities industry on a day-to-day basis; instead separate provincial authorities have been established, mainly because of long-running historical and constitutional factors. This used to be the case in Australia until Federal Government control evolved over the decade of the 1980s. There is some fear at the provincial level in Canada that this process has started there too.

Singapore has adopted a model different from any of those described above, in that its securities and futures markets are regulated by a central bank, namely, the Monetary Authority of Singapore (MAS). Like some other central banks in the world the MAS is not a Ministry but is a quasi-Government authority governed by a board of directors who are accountable to the Singapore Government.

The UK has a complicated system involving a mixture of Government Ministries (the Treasury and the Department of Trade and Industry) and independent regulators, viz. the Securities and Investment Board (SIB) and the Takeovers Panel. The SIB is a corporation established by statute and governed by a board of directors which has delegated its authority to a number of "Self-Regulating Organisations" (SROs) with specific areas of authority - these include agencies to regulate securities and futures dealers, investment management companies and life insurance and unit trust organisations. The Takeovers Panel is a non-Government regulatory body originally established under the sponsorship of the Bank of England and which

administers a non-statutory code of regulations. The UK system is underpinned by sophisticated financial systems and by sophisticated participants who have had to make a substantial commitment both in terms of funding and time taken to participate in the regulatory process.

In my opinion the fewer departments and bodies that are involved in the regulation of the markets, the better. Having numerous regulatory bodies tends to slow the response time of regulators to market developments and initiatives, and tends to create duplication of regulatory effort, which can prove frustrating to both market practitioners and regulators alike. Where there is more than one regulatory body, there needs to be a very clear demarcation of function to minimise problems associated with overlaps of and gaps in responsibility. The immediate past Chairman of the SIB has expressed concerns about the fragmented nature of financial regulation in the United Kingdom.

A further point is that in countries such as China, Australia and Canada, which are geographically large, regulation will normally have to be conducted on some form of regional basis and this raises difficult issues concerning the relationship between regional regulatory authorities and the central authority. Even if there is a Head Office/Branch Office administrative structure, there will be a tendency for Branch Offices to drift away from following the Head Office requirements. The relationship needs to be carefully managed. If there is no central authority it almost certainly follows that regulatory requirements will differ, sometimes significantly, from region to region. In my opinion this situation should be avoided if at all possible because it will almost certainly lead to forum shopping whereby persons who are subject to regulation shop around regulators seeking out the decision which suits them best.

The last point I would like to make concerning the nature of the body undertaking the regulation concerns the structure of the decision-making process.

In some commissions the functions and powers of the organisation are vested in the commission as a whole, which is what I call the "collegiate" approach - in others it is vested in the chairman,

which is what I call the unitary approach. I have a strong preference for the collegiate approach as it requires some form of consensus to be reached. Although the process of reaching consensus can be frustrating, it usually ensures that all views are taken into account. The unitary approach can be confrontational and can produce policies which do not properly balance the various interests of market participants, market integrity and market development. It is most important that the decision-making process incorporates a mechanism to enable those who are subject to regulation to be involved in the development of policies. In order to formalise this process many regulatory authorities appoint advisory boards composed of senior representatives from different areas of the industry.

I now turn to the *second major issue* which I mentioned earlier - *the activities that are to be subject to regulation, which also involves decisions about the classes of persons who will be regulated.*

There are three basic areas of regulation which might be considered, namely, regulation of securities markets, regulation of futures markets, and regulation of the internal affairs of corporations. The first two include as a subset the regulation of persons active in those markets, such as market intermediaries and controllers of listed companies. The third includes as a subset the regulation of directors of corporations.

At the highest level, a decision must be made as to whether all three of these areas will be regulated. Most countries do regulate all three, but it is open for consideration as to whether one regulatory authority should be responsible for regulating all three, or whether the responsibility should be dispersed. If a country is in the fortunate position of starting with a clean slate, there are considerable advantages in having all three areas regulated by one body, especially as there is so much overlap between each.

At the very least it is desirable to have one body regulating both securities and futures markets. In the US, there are two separate national agencies regulating securities and futures. With the

development of innovative financial products, overlaps and uncertainties inevitably emerged and these have created on-going "turf battles" and the need to establish an official accord between the two regulatory agencies. Most countries have avoided these problems and have adopted an administrative model whereby the regulation of securities and futures markets is conducted by one agency.

A similar problem area arises when the administrative model which is chosen makes it necessary to draw a distinction between regulating the securities activities of a company and regulating its internal corporate affairs activities. It is hard to draw a hard and fast line here, but generally speaking securities regulation focuses on ensuring adequate and timely *disclosure* to the market about a wide range of matters concerning the operations and management of a listed company while corporate affairs regulation imposes restrictions on the transactions the management can enter and regulates the relationship between controlling and minority shareholders. Most securities regulators find that disclosure alone is insufficient to prevent conduct by companies that can affect market confidence and need to have rules that at least require shareholder approval of certain types of transaction. Most countries have this problem because they have decided to separate the regulation of these activities. Furthermore, I think many of them made this decision more or less by default - with the growth of public limited liability companies most countries established "Company Registries" which, over time, developed into corporate regulators. As I said before, securities regulators were often established as a political response to a market crisis and so separate regulatory bodies emerged. Be this as it may, establishing separate agencies for regulating securities matters and corporate matters creates problems. For example, in the area of corporate takeovers, which are usually times of intense activity for management, actions by directors which are not in the best interests of minority shareholders can constitute a breach of Takeovers Regulations (usually a securities regulator's function) and also a breach of directors' duties (usually a corporate regulator's function). Australia is one of the few countries in

the world where the central regulatory body looks after both the regulation of the securities market and the regulation of the internal affairs of companies and is therefore able to consider such matters in an integrated manner. However, Australia is an exception with most countries falling into the evolutionary trap I mentioned earlier.

Although China already has a number of ministries at the national and provincial level who are involved in regulating companies and securities, the fact that China's regulations concerning corporate affairs and securities are still in their very early stages gives China the advantage of a relatively clean slate. Whatever is decided, I would urge you to think seriously about choosing regulatory models which maximise integration and minimise fragmentation.

I would now like to focus on the *third major issue*, namely, *the functions and powers to be given to the regulatory body*.

This of course depends to a large extent upon what areas one expects the agency to regulate. For the sake of simplicity I will assume for the moment that we are considering the functions and powers of a securities and futures regulator. In general, such a body will be expected to seek to maintain the integrity of the market, to protect investors and to ensure that the markets develop along sound lines. At the very heart of these functions is a mission to engender confidence that persons, who incur obligations will meet those obligations, or if they don't that there is a means of enforcing them to do so. The integrity of this process is a fundamental cornerstone of any well-functioning market.

To carry out these functions regulators generally have powers to oversee the exchanges and clearing houses through which the markets operate - if we think of a theatrical performance, this is regulation of "the stage". They generally also have powers to oversee the "actors" who play on the stage, including issuers of securities, market intermediaries such as brokers and investment advisers, and their customers.

In terms of regulation of the stage, the usual practice is for the regulator to approve the setting up of the stage, i.e. the exchanges and, thereafter, to oversee changes to the rules relating to how the exchange is to be governed, what is going to be traded, and how the trading and settlement will be conducted.

These oversight mechanisms are the means by which the exchanges are required to demonstrate to the regulator that they have the operational capacity to conduct trading, that they have in place the systemic controls to contain the risks posed by trading, and that they have the controls in place to appropriately regulate both the corporations who wish to have their securities traded and the members of the exchange who wish to deal (both in terms of their dealings with each other and in terms of their dealings with clients). By its power to withhold its approval of rule changes, the regulatory body is able to ensure that the proper controls and risk management structures are in place.

This leads me to a discussion of the role which the exchanges themselves might play as self-regulators. Self-regulation is basically the supervision of an activity by those who participate in the activity - in this case trading in securities or futures. The major advantages of self-regulation are the market experience and expertise that is brought to bear on the regulatory process and its inherent flexibility. Too frequently the Government regulator lacks such expertise. However, effective self-regulation requires appropriate rules, common acceptance of professional standards and the acceptance that such standards must be upheld by fair and firm disciplinary action when they are breached. In my view the development of self-regulation by the exchanges in China should be actively pursued at the same time as the development of statutory regulation. The two processes complement each other.

The regulation of the "actors" on the stage is in some respects more complex, as they are more diverse. In so far as market intermediaries are concerned, regulators usually focus on their entry to and exit from the market (by means of licensing requirements which set minimum standards), as well as their on-going conduct whilst they

participate in the market. The objective is to ensure that market participants generally, and investors in particular, have confidence that the people and organisations with whom they deal are efficient, honest and financially sound, and will treat them fairly.

As for the regulation of issuers of securities, it usually takes the form of establishing requirements concerning disclosure not only at the time of the initial offer, but also on an on-going basis - and of establishing structural requirements relating to the internal operations of the issuer - these cover such things as a minimum track record prior to listing and the minimum size of the public float, etc. This ensures that the market is informed of the intrinsic value of the product that they are dealing in and also sets minimum standards concerning shareholder rights and the structure of the issuing vehicle.

The regulation of issuers also includes the supervision of issuers of collective investment schemes, which also takes place by means of both disclosure and structural requirements, for example, in relation to the form the scheme can take, the role of an independent agent to monitor the scheme, and restrictions and regulations concerning the type of investments that can be undertaken. In most jurisdictions a cornerstone of regulating issuers of public offers of securities and collective investment schemes is the pre-vetting of disclosure documentation prior to the issue or the listing. I am pleased to see that China is adopting this cornerstone.

A further element of the regulation of issuers is the regulation of the process whereby changes take place in the control of a corporation, i.e. regulation of takeovers and mergers activity.

In terms of powers granted to regulators, the most controversial tend to be those related to enforcement - that is, the extent to which the regulatory authority can investigate those who are subject to regulation and take remedial action when things are found to be wrong.

Generally speaking, securities regulators have wide powers to collect information and to conduct enquiries, including investigatory hearings, into the financial position and the market trading activities of intermediaries. More difficult and controversial are the nature and

extent of the powers which the regulators might have to investigate the affairs of listed companies and their managers and controllers, and also the nature of the remedial actions open to the regulatory authority if something is found to be wrong. It is my experience that it is in this area of "corporate fraud" in respect of the affairs of corporations where the potential losses to shareholders and creditors are the greatest but where investigatory and remedial powers are sometimes the most limited.

Another of the major issues for consideration concerns the *form in which the regulatory requirements are to be mandated*.

Broadly speaking there are three major choices:

- statutory, where the requirements are enshrined in law;
- non-statutory codes or guidelines, which do not have the force of law and which depend for their effectiveness upon the willingness of market participants to abide by them; and
- listing rules and broker conduct rules of exchanges and SROs which depend for their enforceability upon the existence of a contractual arrangement between the issuer or the market participant and the exchange or SRO making the rules. Such an arrangement gives the regulator leverage over the regulated; for example, an exchange can threaten to delist or suspend the trading of the securities of an issuer which does not abide by its rules, or impose a monetary penalty or remove the ability to trade in the market from a member who is in breach of the rules.

Most regulatory regimes have a combination of statutory regulation and exchange/SRO rules. The role of non-statutory codes and guidelines is usually, although not always, *de minimis*, because such requirements are difficult to enforce with any degree of certainty. Naturally, for non-statutory codes and guidelines to be effective in the long term, a co-operative spirit must have taken a firm hold, and there must be strong common standards of appropriate market behaviour and practice.

Another question relating to the form of the requirements is whether they are drafted broadly in the form of general principles, or whether they are drafted as very detailed and specific regulations. If the requirements are drafted as general principles then there is the benefit of them being flexible and quickly adaptable to changing market situations and new products, but there is the disadvantage that they might not be specific enough for particular market situations. The Hong Kong Code on Takeovers and Mergers relies on a number of broad, general principles of how changes in corporate control should be conducted, while at the same time using explanatory notes to provide market participants with an idea of how these principles are interpreted and applied in various situations. Such explanatory notes need constant updating and revision to take into account new market circumstances. As the Code is non-statutory it can be easily amended, but such a process would be much more cumbersome if the Code was enshrined in legislation.

## **Conclusion**

As you can see, the question of which regulatory structure is best suited for China's needs and circumstances is a complicated one. I hope that by raising some of the key issues I have been able to shed some light on the choices which are open to you.