

Challenges in regulating emerging capital markets

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1. Regulating capital markets in emerging countries can be a challenge. Events can change so quickly. Take the example of Thailand. Within the last 6 months, we had 3 major events that violently shook the market. There was a coup d'etat, a capital control measure and a proposal to tighten the enforcement of the law on foreign shareholding limits. All these events depressed the market. The capital control measure alone caused the market to drop 15 per cent in one day. And all these were done without any consultation with us the securities regulators. Well, for us, that was definitely a challenge. But when I look around, I believe that regulating emerging markets as diverse as the ones that we have in Asia - - is not only a real major challenge but also a subject that should be thoroughly discussed and shared. I am therefore grateful to ASIC for inviting me to share some thoughts with you today.

2. Emerging capital markets are small in size, and tend to be fragmented in the variety of companies. Take the example of Thailand. The market cap of our stock market is just under US\$ 150 billion. It is only one seventh compared to Australia. It comprises fewer than 500 listed companies, while the Australian market has almost 1,800. Both of our markets have very much the same profile in that a few large companies dominate the market cap, while there are many small companies in the bottom quartile. It may lead one to assume that work of the regulators in both markets are very much the same.

3. Regulators in any country are tasked with investor protection and ensuring fair markets. It is understandable for people to think that we do the same work. However, there are certain differences in term of what type of work we emphasize. I remember that the first time I read annual reports of securities regulators in some developed countries, I saw that heavier emphasis was made on the type of work relating to the consumers, especially in their dealing with intermediaries. A lot of effort is put into ensuring that fund managers and stock brokers treat them fairly. To ensure that investors are aware of their rights. To have channels for consumers that had been unfairly treated to file complaints. Many cases seem to revolve around bad professional advices, unclear documents and unsuitability of risks.

4. In Thailand we also give importance to consumer protection, but the intensity is somewhat less. Perhaps it is because Thai savers are still not that much adventurous and still prefer traditional products. Instead we seemed to be spending a lot of our resources on enforcement. What kind of work do we spend a lot of time on?

5. The first type is the work on preventing and prosecuting the siphoning of money out of public companies to the major shareholders. This is not to say that Thailand has more than our fair share of these siphoning activities. But if the few that do this are allowed to get away with it, others may be tempted to also cross the line. In the past there had been companies that lent money to businesses related to the major shareholders which later

became bad debts. There had also been companies that financed projects - - for which if there were upside gains, the benefits would accrue to the major shareholders, while if there were downside risks, the risks would be borne entirely by the companies. Eventually the companies were saddled with project losses.

6. My first reaction was that we should prosecute these managements for embezzlement. Unfortunately, I found that we could not. All of these dubious transactions had been put forward to the shareholders' meetings for retrospective validations. For some reasons, the resolutions were passed. These managements therefore could not be prosecuted.

7. To guard against future abuses of this type, we announced a measure. Any company wishing to table transactions that are connected to the major shareholders to the shareholders' meetings would henceforth have to send a copy of the documents also to the SEC. Our staff will read through the proposal. If we find it to be one sided, or unclear as to the risks to be borne by the companies, we shall make public announcements to highlight the issues. We would try to alert the small shareholders to look into the issues carefully. We would also try to push for fund managers that hold shares in those companies to be active and raise queries in the meetings. The idea is to engage in active public debates so that the managements will be forced to make their proposals under the lime light. In this example, you can see that regulators in emerging markets may need to have a more active role in stimulating shareholder activism than those in the more advanced markets.

8. The second type of work that occupied a lot of my time was the financial accounts of listed companies. I must state from the outset that in Thailand, the international big four command as much as 63% market share of the audit by market cap. One would have thought that I would not need to lose any sleep on the issue of accounting and auditing given such dominance. But it was not so. I noticed that previously there were transactions that window dressed the accounts to show more profits than there actually were. In some cases, the provisions for bad debt were inadequate. In other cases, the valuations of assets were overstated. The auditors would be uncomfortable with these transactions. But they would allow them regardless. They would give the accounts clean opinions. They would protect themselves by using what is called the paragraph that emphasizes certain matters. This is one of the paragraphs in the audit opinion. In this paragraph, the auditor would show some vague concern about the transactions in question. They would describe it as being uncertain, making them giving the benefit of the doubt to the companies.

9. I immediately put a stop to this. I issued a ruling that henceforth, the SEC would not accept the filing of company accounts with clean opinion, if it should also have this emphasis paragraph. We would accept such a paragraph only if there is a good and valid reason for it to be so. Basically, the auditors were forced to come down from the fence. If they cannot live with the questionable transactions, they have to qualify the accounts. If instead they go for clean opinion, they must be prepared to be naked. They can no longer protect themselves by using the emphasis paragraph.

10. After we showed them that we meant business, the auditors complied. As a result, the target unfortunately moved on - - from the auditors to the accountants, the book keepers of the listed companies. When they cannot get their auditors to help, they began to

lie to the auditors. Previously we were able to identify the problem transactions easily just by going through the emphasis paragraph in the auditor's reports. But when companies lied to auditors, these items are no longer highlighted. How do we pick them out?

11. I am indebted to the Securities Commission of Malaysia for the solution. We set up an internal group to analyze quarterly accounts of companies that we put on our watch list, some 50-60 companies or so. We compare items line by line. When we see unusual changes, we telephone the companies for explanation. If the explanation is not satisfactory, we order the companies to conduct a special audit focusing on the issues. We can then trace flows of cash through bank accounts to establish linkage, if necessary, and give all this information to the auditors.

12. With this system of the SEC, working together with the companies' auditors, we have been able to order corrections to the accounts as well as file cases with the police for frauds and embezzlement. If you think that was a happy ending to my story, I am afraid to disappoint you. Lately, the crooks have gone one step further. We have started to see a few cases of profit fabrication in listed companies - - created by the companies buying or selling goods or services with their subsidiaries which are non listed companies. The buying and selling were not done at arm length prices.

13. Normally, the above normal level profits in the parent company will be canceled out by the equivalent losses in the subsidiaries when the accounts are consolidated. However, in these cases, the management tried to hide the parent-subsidiary relationship by using private individuals to hold shares in the subsidiaries, instead of the parent company. These individuals, on the surface, would seem to be unrelated to the parent companies, or the major shareholders. They therefore claimed that the companies were unrelated. They wanted to show profits in the listed companies and hide the equivalent losses in subsidiaries that are not listed.

14. Fortunately, up to now we have been able to identify some links. For example, our field investigation had found those individuals to be employees or directors in the businesses that were related to the major shareholders. Or, our tracing through bank accounts had found the cash going back to businesses that were related to the major shareholders. But I am sure that in future it will be more and more difficult to find the audit trail. There can be even more complication arising because some of these dubious transactions may be deals that are done across borders.

15. Let me summarize that in this example, emerging market regulators may need to be more vigilant on accounting frauds than the more developed markets. And that we may begin to see some of the transactions involved done across borders. It will therefore require close cooperation among regulators to put things in order.

16. The third issue that I wish to mention is the work on stock price manipulation. Price manipulation is an offense under our law. In the past, we were able to prosecute some cases by tracing the flows of cash through bank accounts. Invariably, the cash would originate from the mastermind, the ring leader. Then it would go out to other members in

the ring to support the orchestrated buying and selling of stocks. Finally, after the rounds were done, the cash would go back to the ring leader together with the profits.

17. Lately, however, we began to see the activities done not in a ring, but among syndicates. The syndicates consist of rich individuals, many of them politicians. Each member would be able to finance all the purchases by themselves. Therefore there was no cash movement between members of the syndicate. Not only there was no way to establish the relationship using cash trails, but the purchases and sales by each member were also too small to be deemed as market moving transactions. The only clear evidence was that the same group of people moved into the same stock, ramped up the price, attracted the following of day traders, then they sold and moved on to another stock. We debated about the usefulness of asking for mobile phone records. But we could not be entitled to their voices, only the phone numbers that each person called. The linkage would be too weak.

18. What I have described may perhaps be peculiar only to emerging markets. The syndicates work on penny stocks. And there is a big group of day traders who follow these syndicated. They trade on rumors. They thrive on tips from marketing officers as to which stock was hot for the day. They even resent intervention by regulators. They think that they can look after themselves well, even after they might suffer some losses here and there. Their hope is to get the tips earlier in the game the next time so that they can make some money, for a change.

19. Emotions can run high in these events because it involves large sums of money. I once had a bullet put into my mail box at home with a note saying that the next time it would be delivered directly into my body. You can see then in this third example that in the area of market conducts, regulators in emerging markets may be kept busier in this area than the advanced markets. Again another trend that we observe is that more and more of the buy/sell orders by the syndicates come from overseas. It again points to the need for closer cooperation among regulators in the future.

20. Finally, I shall mention our work on the computation of net asset values of mutual funds. It may strike you as odd as to why regulators have to look into this issue. The reason is that in emerging markets, fair values of debt securities are often difficult to obtain, even for government bonds. Before I took office, the prevalent practice among mutual funds that invest in off the run issues was to calculate net asset values not using the true market clearing prices. Since these securities were not actively traded, they claimed that they could more accurately calculate the prices based on extrapolation. Unfortunately, the calculations were done in house. There was therefore a tendency for them to skew the prices in order to dampen the volatility of price movements. They wanted to show smooth movement of the net asset values of the funds under their management. This practice made it impossible to effectively compare the results between funds. It also made it unfair to the unit holders that sell the funds that are undervalued and to the unit holders that buy the funds that are overvalued.

21. The practice was supposedly meant to sooth the feeling of unit holders against panic in case of wide market fluctuations. Unfortunately, when the bond market had a severe and prolonged down turn, it also had the affect of overvaluing the net asset values as the bond

prices trend down. In 2003, Thailand had just that kind of bond market. Of course, when the market turns down, one can expect some withdrawal from bond funds. But because of the overvaluation of the “off the run” issues, when the withdrawals reached the point where the funds were forced to actually sell those securities, they, of course, realized prices below their previous calculations. This led to the net asset value in the week that followed to be down more than the market movement would normally imply. Some unit holders started to notice that if they redeemed their units in week number one, they would get better prices above market than they would if they should redeem in the week number two. It naturally led to more redemption - - which in turn forced the funds to actually sell more of those overvalued securities - - and resulted in more net asset value drop. The cycle went on and on until a massive 41% of NAV of the open ended bond funds were redeemed in the period of just three months. It was a run on mutual funds the like of which Thailand had never seen before.

22. We have since put things right by first forcing all funds to hold more liquid “on the run” securities so that they can better withstand redemption. The second measure was to push a self regulating organization on bond markets to perform the task of pricing agent for “off the run” securities. In this instance, you can see that regulators in emerging markets may also have to be involved in work on market mechanism. Something you need not do in advanced markets.

23. I hope that in this short presentation, I have succeeded in giving you some flavor of the life and work of regulators in emerging markets using Thailand as an example. I hope that you not only find it of some interest, but also perhaps have some wisdom or suggestions that we can learn from in the discussion to follow.