

RESTORING INVESTOR CONFIDENCE: AN APPROPRIATE SANCTIONS REGIME FOR THE GLOBAL MARKET

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ABSTRACT

The phenomenon of globalisation has erased national boundaries and re-cast national capital markets into a part of the global market. In so doing it has created challenges to the global regulatory structure. Recent turmoil in the financial markets of South East Asia and its wide sweeping and devastating effects have highlighted deficiencies in the capital markets. The inability of a country's financial system to cope with the rapidly changing landscape of global financial markets brings home the point that urgent action must be taken to restore the shattered confidence of investors. In the context of globalisation, it is no longer sufficient to address the issue of investor confidence purely from a national perspective. Coordinated international efforts are a pre-requisite for providing safeguards that are so necessary to restore that confidence. This article canvasses the view that an appropriate uniform sanctions regime would be one important regulatory strategy which aids in the process of instilling faith in the fairness and integrity of the international markets.

INTRODUCTION

The ill wind that is sweeping the South East Asian capital markets is biting and is expected to leave in its wake a trail of lost fortunes and broken careers which in many cases have taken years of toil, thrift and hard work to build. The economic miracle of the 1980s and 1990s which earned the developing countries in Asia the name of "Tigers" has virtually disappeared, leaving only the "battered economies".

GLOBALISATION

Part of the current problem stems from 'globalisation' or 'internationalisation' of the world's commercial and financial markets which occurred only within the last two and a half decades. The market of a country is no longer confined within its geographical boundaries but is treated as part of one big global capital market. The high level of integration of the capital markets has been brought about by great leaps in communication, technology, information processing and, more importantly,

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the deregulation of trade and finance. Removal of government control over these two sectors in a number of trading nations has helped to broaden the horizons of borrowers, traders and investors and made it possible for them to have a choice of dealing in capital market instruments anywhere in the world, particularly in the more established centres of New York, London and Tokyo. It has also made it possible for giant hedge funds and other well-resourced organisations to utilise their considerable wealth to target particular vulnerable currencies and securities markets, causing them to rise or fall.

DERIVATIVES

In this manoeuvre, the global players are aided by the use of derivatives.¹ The term "derivatives" is a generic name used to describe certain financial contracts which are principally employed to manage financial risk.² A derivatives transaction has also been defined as:

"a bilateral contract or payments exchange agreement whose value derives, as its name implies, from the value of an underlying reference rate, or index. Today, derivatives transactions cover a broad range of 'underlyings' - interest rates, exchange rates, commodities, equities and other indices."³

Derivatives comprise of two main categories - futures (which term is used here to include also forwards and swaps) and options.

The negative effects of globalisation would not have been so severe had it not been for the availability of these instruments. Derivatives, in general, require very little capital outlay but offer the prospects of high returns. A speculator is able to take advantage of the leverage afforded by a derivatives instrument as it costs only a fraction of the actual price of the underlying asset.⁴ The lower cost of the derivatives contracts enables the speculator to buy rights, for example, an option, over a greater amount of the underlying than would have been possible had the speculator bought the underlying itself. Derivatives, therefore, provide a trader with an effective means of influencing the direction of the underlying, be it a currency or a particular stock or share or an index such as the Kuala Lumpur

¹ See Walsh, M, 'MX Missile Lurks in Hidden Deals', *Sydney Morning Herald*, 11 November 1997, 27-28.

² Derivatives are also used for arbitrage and speculation for profit although hedging and risk management purposes are the most common.

³ Group of Thirty, *Global Derivatives Study Group*, 'Derivatives: Practices and Principles', Washington, 1993, 3.

⁴ The term 'underlying' includes a broad range of assets - currencies, interest rates, exchange rates, commodities, equities and indices.

Composite Index (KLICI) because, for a given amount of money, he or she would have the opportunity of controlling a larger portion of the underlying.

LOSS OF POLICY AUTONOMY

Globalisation when combined with the use of derivatives is a lethal force which, if left uncontrolled, could have ramifications for governments. It could result in governments relinquishing aspects of national sovereignty and cause them to lose their policy autonomy.

For example, it is widely accepted that the current crisis affecting much of South East Asia originated from speculative exercises on the Thai baht⁵ and that contagion effect caused the depreciation of currencies and rising interest rates in neighbouring countries, including Malaysia and Indonesia.

The Thai baht debacle is not an isolated case. Recent history has shown that even countries with larger economies are not immune to having their monetary policies derailed.

In 1992, the British Treasury was rendered helpless when speculative market play forced the British Pound to fall out of the European exchange mechanism after the then Chancellor of the Exchequer, Mr Norman Lamont, failed to halt the pound's slide despite raising interest rates twice within a mere few hours. It was rumoured that George Soros' Quantum Fund was behind the assault on the pound and that Quantum Fund made one billion US Dollars on that occasion.⁶

Similarly, in early 1994, the United States failed in its attempt to ease long term interest rates in the bond market due to speculative play. The US Treasury had, on 4 February 1994, raised short term interest rates in the hope that a tightening of monetary policy which would contain inflationary pressures, would reassure the markets and manifest itself in an easing of long bond interest rates. However, due to the use of derivatives contracts by speculators to punt billions of US Dollars into the bond market, that exercise was unsuccessful. Contrary to expectations, long bonds yield increased 1.75%.⁷

⁵ See, for example, Khor, M, 'Foreign players must share blame', *The Star*, 4 August 1998, 20; Walsh, M, note 1.

⁶ Kelly, R & Hudson, A, 'Hedging on futures: regulating the derivatives markets', *Fabian Society*, London, November 1994.

⁷ Kelly, R & Hudson, A, note 6.

A PATHWAY TO INVESTOR CONFIDENCE

The above examples have been cited merely to highlight a significant problem of this modern era, brought about by the dismantling of barriers in the capital markets, advances in technology and inventions of rocket scientists.⁸ If a nation's monetary policies can be brushed aside by the economic might of market players, something needs to be done to ensure that their powers are used in a proper and acceptable manner.

Whilst the government has moved swiftly to insulate the Malaysian Ringgit by re-introducing exchange controls and pegging the Ringgit to a fixed rate of exchange against the US Dollar,⁹ this is expected to be a short term measure and a long term solution needs to be found.

Although there are a number of regulatory strategies¹⁰ which could help to water down the dominance of the super rich market players, this article focuses on only one pathway, namely, an international agreement for an appropriate sanctions regime to outlaw unfair, manipulative, misleading or deceptive conduct in the global market place. It is submitted that such a strategy should help to restore some level of investor confidence.

THE RATIONAL FOR REGULATING AGAINST UNFAIR MARKET PRACTICES

A sanctions regime directed at unfair market practices is one of the key regulatory instrument used to foster investor confidence. In the absence of statutory protection against undesirable market practice, perpetrators could stand to reap unjust profits. Manipulative or unfair practices would drive away genuine market participants as in such a situation, these traders can no longer be sure that the prices of derivatives, commodity or securities contracts being traded are a genuine reflection of the market forces of supply and demand and not a result of manipulation by players. Therefore, the prohibition of undesirable practices coupled with suitable remedies to punish offenders is a necessary ingredient for maintaining investor confidence in the integrity, fairness, and efficiency of the capital markets.

⁸This term refers to Wall Street's brilliant inventors of new financial derivatives products, constructed from basic derivatives such as options, swaps, and futures.

⁹The fixed rate of exchange is currently USD1=RM3.80.

¹⁰Such strategies include international agreements on the imposition of a higher level of capital adequacy requirements for banks and other intermediaries dealing in derivatives; increasing margin requirements on market players and introducing regulation to curb speculation in industries such as pension funds, insurance and local government authorities so as to reduce the overall size of the derivatives market and thereby reducing the chances of disruption or uncertainties in the capital markets:

EXAMPLES OF MANIPULATIVE AND UNFAIR PRACTICES

To set the argument in context, it is perhaps appropriate to discuss some of the more common forms of malpractices which could distort market prices and lead to a loss of confidence in the markets. The unfair techniques used by traders in pushing up or down or maintaining the prices of a commodity include:

(a) Corners

"Corners" is a term used to describe a situation whereby a speculator attempts to monopolise a particular commodity on the markets by buying more than the available supply of that commodity. A corner is achieved in a situation where one or more speculators, who hold long positions¹¹ on futures contracts ("longs") in excess of the amount of a commodity, monopolise that commodity. The monopoly by the longs means that those who hold short positions¹² are unable to deliver on their contracts forcing them to buy from the longs at a price that is dictated by the longs.¹³

(b) Squeezes

A "squeeze" is similar to a corner except that the scarcity of the commodity is not due to the manipulation of the speculators but, in the case of futures contracts, factors such as floods, drought or other causes¹⁴ making it possible for exploitation by the longs or speculators to hold out for a high price.

(c) Wash sales

This is essentially a sale of securities or a commodity by a person to himself or herself. The transaction does not involve a change in the beneficial ownership of the subject matter of the sale.¹⁵ Wash sales is a practice which could take place both in the physical market and in the futures market with the simultaneous sale and purchase of a contract by the same person.¹⁶ It is intended to foster the appearance of an active market in the hope of influ-

Kelly, R & Hudson, A note 6.

¹¹ A person holding a long position has more purchases in a commodity or currency than sales, giving that person a positive asset position in that commodity or currency.

¹² A person is said to hold a short position if that person has more sales contracts than bought contracts. This is the opposite of a long position.

¹³ *Cargill Inc. v Hardin*, 452 F.2d 1154, at 162 (8th Circuit 1971) cited by Currie, JS, *Australian Futures Regulation*, Longman Professional, Melbourne, 1994, 223.

¹⁴ Currie, JS, note 13, 223.

¹⁵ Hambrook, JP, 'Liability for Misconduct in Securities Transaction' in *Australian Corporations Law: Principles and Practice*, Vol 2, Butterworths, 1991, 73, 144; Baxt, R. et al., *Stock Markets and the Securities Industry-Law and Practice*, Butterworths, Sydney, 1988, 73, 121.

¹⁶ Currie, JS, note 13, 229.

encing others to purchase the securities or futures contracts.

The above are but some of the more common examples of undesirable market practice. If there are no laws in place to prohibit abusive practices, unscrupulous traders could manipulate the markets, with impunity, to their advantage. These sharp market practices could cause financial loss to investors and erode their confidence.

A PERCEIVED REGULATORY GAP

The current problem is that whilst market abuses in a number of countries are prohibited by law, it is unclear the extent, if any, of the reach which the laws of these individual countries have beyond their national boundaries. For example, in the context of Australia¹⁷ and the United States,¹⁸ commentators have suggested that the extraterritorial effect of market manipulation provisions of these countries are limited. In consequence, traders may have the opportunity of exploiting the regulatory gaps by tailoring their undesirable activities in such a manner that those activities fall outside the ambit of prescribed conduct of individual countries.

In part, the problem may be attributable to an antiquated regulatory structure which in many countries pre-date the advent of globalisation and the new generation of derivatives. As a United States writer¹⁹ observed:

"In every country, however, it is safe to say that the pace and imagination of the market in building and using derivatives has far outstripped the regulatory framework's ability to adjust."²⁰

Arguably, the gaps arising from jurisdiction are exacerbated by outdated definitions in securities and futures legislation which fail to take into account the spectrum of financial derivatives now available in the markets. This failure would mean that derivatives which are not within the ambit of national securities and futures legislation will be unregulated and will not be subject to the penalties imposed under such legislation for undesirable market practices. The failure by the existing legislation in some

¹⁷Ryland, M, 'Derivatives Regulations - The International Aspect', *Journal of Banking and Finance Law and Practice*, Vol 5 No 3, 1994, 173 at 184; Black A, 'Regulating Market Manipulation: Sections 997-999 of the Corporations Law', *The Australian Law Journal*, Vol 70, 1996, 987 at 1002-1003.

¹⁸Black, A, note 17 at 1003.

¹⁹Petzel, TE, 'Derivatives: Market and Regulatory Dynamics', *The Journal of Corporation Law*, Fall, 1995, 95.

²⁰Petzel, TE, note 19, 95.

countries to bring within their purview all classes of derivatives and to address adequately the extra-territorial issues inherent in cross border transactions have created regulatory gaps. These issues need to be considered in the design for a regulatory model suitable for the international markets.

AN INTERNATIONAL APPROACH

A national regulator is unlikely to wish to assume the functions of a universal regulator in view of the administrative burden and costs that such a role will impose. Realistically, each national regulator would be left to patrol its own turf. However, the global nature of the capital markets demands that some form of a unified approach be adopted. This is necessary because the borderless nature of the markets raises issues in relation to the scope of regulation of individual countries, regulatory overlap and the methods of enforcement.²¹

Apart from these, there is also a need for international consistency in what constitute an offence and this, in turn, depends on consistency in definitions and in framing the gravamen of an offence. As alluded to above, inconsistency in definition of an offence could mean a particular conduct being treated as an offence in one country while not considered an offence in other countries. Resolution on these issues can be settled only by consensus of all or at least a large majority of nations. In the absence of a coordinated approach, any effort to regulate the capital markets by individual countries could be frustrated as regulatory gaps would be likely to remain.

Also, if regulation is not internationally consistent, it is expected that undesirable practices would move to countries where such practices are not proscribed, resulting in regulatory arbitrage and, at the same time, providing a "safe haven" for offenders.

For this reason, the international community should put together a set of uniform regulation which then be adopted by all countries, either in toto or with such minor modification as may be necessary to suit local conditions. Any deviation from the internationally agreed standards should be made only after careful consideration as differences could give rise to regulatory arbitrage.

The uniform legislation is expected to:

- proscribe undesirable conduct including insider trading, hawking,²² frontrunning²³ and buck-

²¹Ryland, M, note 17, 173.

²²This term refers to the practice of going from place to place to invite subscription or to offer shares or other securities to potential buyers.

eting,²⁴ manipulative conduct including such as churning,²⁵ wash sales, matched orders,²⁶ and other market ringging activities, corners and those others involving misleading, deceptive or unconscionable conduct and conduct involving fraud; and

- provide an appropriate remedy or sanction for contravention.

In drafting the offences provisions, account should be taken of other factors including the following:

- the implications of cross border transactions, whether by electronic or other means; and
- the effect which movement on the derivatives market would have on the underlying or related markets.

Additionally, the regime should clearly define each nation's scope of extraterritorial jurisdiction so that regulatory overlap of jurisdiction between countries be kept to a minimum.

A suitable forum for such a proposal to be considered may be the Basle Committee and the International Organisation of Securities Commission (IOSCO) which were formed with the objective of improving the quality of the world's financial markets and responding to the developments taking place in the global market place.²⁷

²³Frontrunning refers to a situation in which the broker allows the sequence of transmission and execution of orders to apply in such a way that the broker has an advantage over the client. For example, a broker may be tempted to enter the futures market ahead of its client and in competition with that client if the broker is aware that the client has placed or is soon to place a significant order which has the capacity to influence price in a particular futures market. Frontrunning is prohibited by section 54 of the Futures Industry Act 1993.

²⁴Bucketing occurs when a broker accepts a client's orders for sale or purchase of a futures contract (intended to be executed on a futures market) but fails to pass on the order for execution either in the OTC market or on the floor of the exchange. Instead the broker does one of two things: either takes the other side of the transaction, acting as a principal or alternatively, the broker matches the client's orders with equal and opposite orders of the broker's other clients to maximise its profit Bucketing is an offence under section 80 of the Futures Industry Act 1993.

²⁵"Churning" occurs where, for example, a dealer who has control or discretion over a client's account induces excessive and frequent transactions in the client's account so as to benefit itself.

²⁶Matched orders are orders placed by a person and his associates to buy and sell at the same time, for substantially the same number of securities and at substantially the same price. See Black, A. note 17, at 999. Like wash sales, the intention is also to create an impression of active trading.

²⁷Companies & Securities Advisory Committee, 'Regulation of On-exchange and OTC Derivatives Markets, Final Report', June 1997, paragraph 1.17.

Alternatively, national market regulators could initiate discussions among themselves with the objective of reaching an agreement on a set of uniform regulation which would be acceptable to all. The Windsor Declaration is an example of what could be achieved on the international front by the co-operation of national regulators acting together. This Declaration, which in essence is an agreement reached among market regulators²⁸ in May 1995 to enhance international co-operation and exchange of information among themselves, helps to improve the arrangements for the supervision of the global futures market.

CONCLUSION

It is recognised that the problems arising from the international nature of the markets require a holistic approach and that a sanctions regime is but one of the issues that needs to be tackled by the international community. There are other issues, both legal and regulatory, which exist and these have been studied and discussed in a number of reports²⁹ including those by the Group of Thirty,³⁰ the United States General Accounting Office,³¹ and the Australian Securities Commission.³²

One proposal which has been canvassed is an international agreement on the control of risks, particularly systemic risk, which rightly is of concern to regulators worldwide in view of its domino effect. Whilst there is agreement on the imposition of capital adequacy standard to control risk, there is considerable disagreement on the level of the capital charge and the methods by which it should be calculated.³³ It is submitted that what has been proposed in this article, namely a universal sanctions regime, would be a much easier proposition upon which international agreement could be attained as the same economic or "white collar" crimes occur in all jurisdictions and need to be combated in much the same way.

²⁸The regulators were from the United States, United Kingdom, Australia, Brazil, Canada, France, Germany, Hong Kong, Italy, Japan, Netherlands, Singapore, South Africa, Spain, Sweden and Switzerland.

²⁹A number of these reports were highlighted in Ryland, M. note 17 at 191.

³⁰Group of Thirty, note 3.

³¹See United States House of Representatives, *Review of Reports by the US General Accounting Office and the Commodity Futures Trading Commission on Derivative Products*, a hearing before the Subcommittee on Environment, Credit and Rural Development of the Committee on Agriculture at the One Hundred and Third Congress, Second Session, June 14, 1994, US Government Printing Office, Washington, Serial No 103-75.

³²Australian Securities Commission, 'Report On Over-The-Counter Derivatives Markets', 1994.

³³Ryland, M. note 17 at 191.

It is expected that a uniform sanctions regime will not only level the playing field for all investors of the global capital markets but will also help to reduce systemic risks by bringing the sanctions regime to bear on all those who indulge in unfair practices, where-ever they may be, including those super rich traders whose activities are carried out across international boundaries. As McGarvie J said in *Barry James Rumpf*.³⁴

“...the criminal law should not operate so that the ordinary and impecunious criminal receives the full measure of due sentence while the powerful, wealthy and educated criminal who engages in sophisticated forms of crime receives less than the due sentence...”

While a uniform sanctions regime is not a cure-all solution, it is nevertheless an effective tool in the supervision of the market players and would constitute a definite improvement in regulatory environment for international traders. As such, the regime should contribute to a restoration of investor confidence in the markets.

³⁴(1987) 29 A Crim R 252 at 264; quoted in Paper by the Director of Public Prosecutions to the Joint Parliamentary Committee on Corporations and Securities, 7 September 1992.