

AIIFL

Launch Conference of
ASIAN INSTITUTE *of*
INTERNATIONAL FINANCIAL LAW

Challenges for the
New International Financial
Architecture:
Lessons for East Asia

June 4-5, 1999

The University of Hong Kong
Faculty of Law

Celebration of the Faculty's 30th
Anniversary

Co-sponsored by
Centre for Commercial Law Studies (CCLS),
University of London;
Financial Law Institute, Peking University;
SMU Law School,
Institute of International Finance and Banking;
Korea Institute of Finance;
Centre for Corporate Law and
Securities Regulation,
University of Melbourne;
Postgraduate Programme in
International Business Law,
University of Zurich;
London Institute of International Banking,
Finance and Development Law

This conference is part of a series
of

GLOBAL CONFERENCES ON THE
"NEW INTERNATIONAL
FINANCIAL ARCHITECTURE"

Cologne, March 22-23, 1999
Financial dispute resolution

Dallas, March 25-27, 1999
Law-based nature of the new
international financial
infrastructure

Johannesburg, April 21, 1999
Impact of new architecture on
developing
financial markets in Southern
Africa

London, May 24-25, 1999
Future role of IMF and a critical
evaluation
of the Russian financial crisis

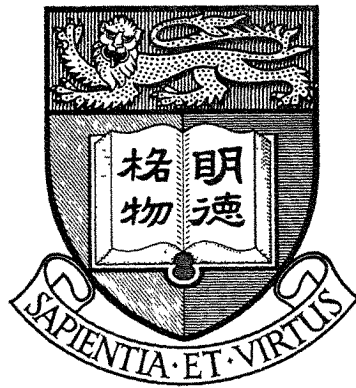
Hong Kong, June 4-5, 1999
Challenges for the new
international financial
architecture:
lessons for East Asia

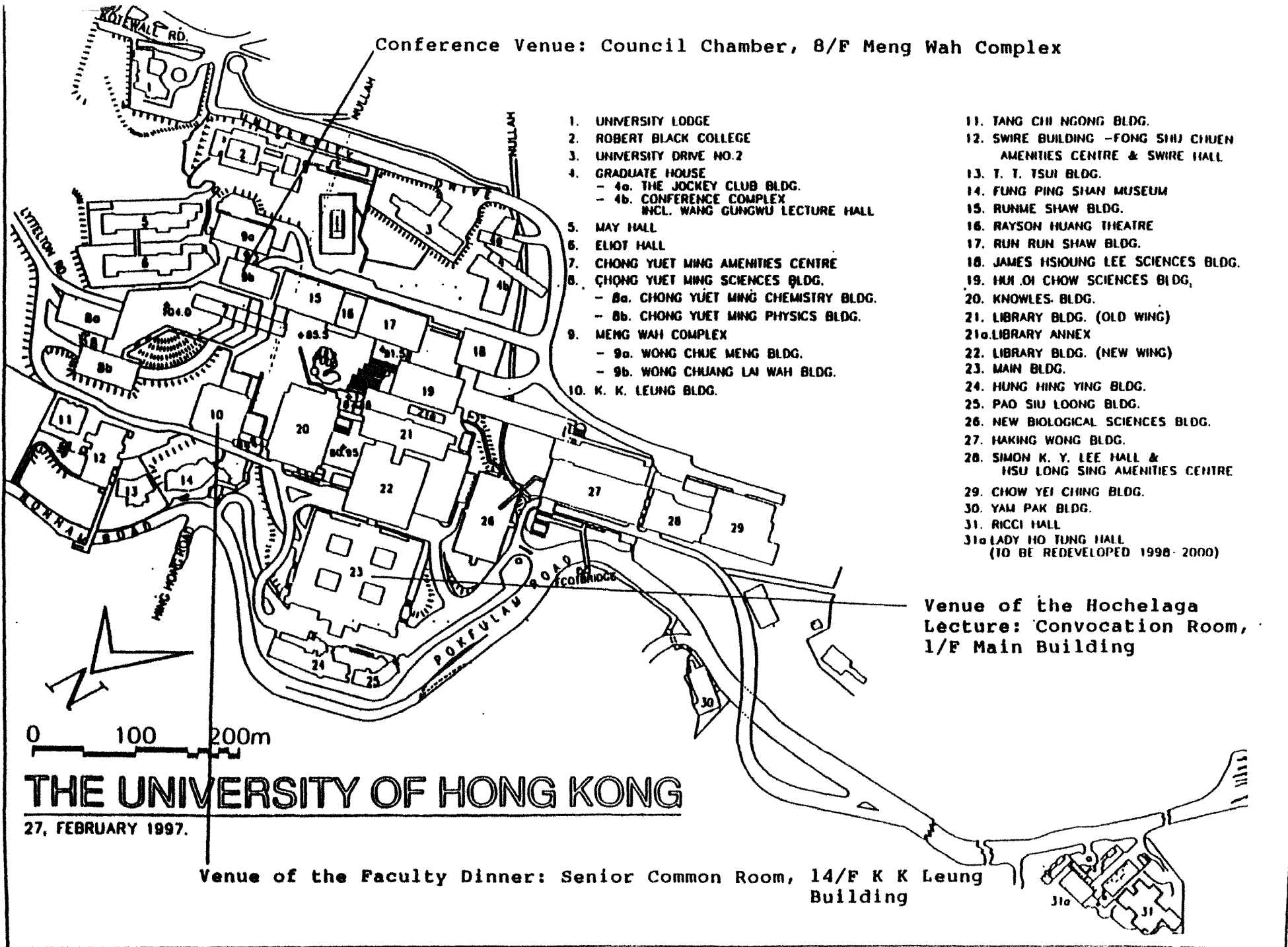
Bangkok, June 7-9, 1999
Impact of the IMF restructuring
programs on banking law reform:
in Thailand and related Southeast
Asian Countries

Montevideo, July 1999
Financial sector reform in the
Southern Cone

*The kind support of
the Sir John Lubbock Support
Fund (London)
and
Dorothy Lee Trust (SMU)
is gratefully acknowledged*

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Conference Venue: Council Chamber, 8/F Meng Wah Complex

- 1. UNIVERSITY LODGE
- 2. ROBERT BLACK COLLEGE
- 3. UNIVERSITY DRIVE NO.2
- 4. GRADUATE HOUSE
 - 4a. THE JOCKEY CLUB BLDG.
 - 4b. CONFERENCE COMPLEX INCL. WANG GUNGWU LECTURE HALL
- 5. MAY HALL
- 6. ELIOT HALL
- 7. CHONG YUET MING AMENITIES CENTRE
- 8. CHONG YUET MING SCIENCES BLDG.
 - 8a. CHONG YUET MING CHEMISTRY BLDG.
 - 8b. CHONG YUET MING PHYSICS BLDG.
- 9. MENG WAH COMPLEX
 - 9a. WONG CHUE MENG BLDG.
 - 9b. WONG CHUANG LAI WAH BLDG.
- 10. K. K. LEUNG BLDG.
- 11. TANG CHH NGONG BLDG.
- 12. SWIRE BUILDING -FONG SIU CIJEN AMENITIES CENTRE & SWIRE HALL
- 13. T. T. TSUI BLDG.
- 14. FUNG PING SHAN MUSEUM
- 15. RUNME SHAW BLDG.
- 16. RAYSON HUANG THEATRE
- 17. RUN RUN SHAW BLDG.
- 18. JAMES HSIUNG LEE SCIENCES BLDG.
- 19. HUI OI CHOW SCIENCES BLDG.
- 20. KNOWLES BLDG.
- 21. LIBRARY BLDG. (OLD WING)
- 21a. LIBRARY ANNEX
- 22. LIBRARY BLDG. (NEW WING)
- 23. MAIN BLDG.
- 24. HUNG HING YING BLDG.
- 25. PAD SIU LOONG BLDG.
- 26. NEW BIOLOGICAL SCIENCES BLDG.
- 27. HAKING WONG BLDG.
- 28. SIMON K. Y. LEE HALL & HSU LONG SING AMENITIES CENTRE
- 29. CHOW YEI CIJING BLDG.
- 30. YAM PAK BLDG.
- 31. RICCI HALL
- 31a. LADY HO TUNG HALL (TO BE REDEVELOPED 1998-2000)

Venue of the Hochelaga Lecture: Convocation Room, 1/F Main Building

Venue of the Faculty Dinner: Senior Common Room, 14/F K K Leung Building

THE UNIVERSITY OF HONG KONG

27, FEBRUARY 1997.

**The University of Hong Kong, Faculty of Law
and its**

Asian Institute of International Financial Law

(Institute subject to University approval)

present

International Conference

on

**“Challenges of the New International Financial Architecture:
Lessons for East Asia”**

Date: 4-5 June 1999 (2 day Conference): Friday and Saturday Working Sessions

Academic Co-Sponsors:

Centre for Commercial Law Studies (CCLS), University of London

Financial Law Institute, Peking University

SMU Law School, Institute of International Finance and Banking

Korea Institute of Finance

London Institute of International Banking, Finance & Development Law

Post-graduate Programme in International Business Law, University of Zurich

Centre for Corporate Law and Securities Regulation, The University of Melbourne

Planning Committee:

Mr. Anthony Neoh, QC, SC,

Ms. Alexandra Lo

Chair

Dean Albert Chen

Mr. Michael Liu

Mr. Stefan Gannon, JP

Mr. Kenneth Ng

Mr. Say Goo

Professor Joseph Norton

Professor Y.C. Jao

Mr. John Thomas Shingle

Mr. Donald Koo

Mr. Raymond Tong

Mr. Larry Kwok

Professor Ted Tyler

Mr. Robert S K Lee

Mr. Benjamin Vandegriff

Venue:

Council Chamber, 8th Floor, Meng Wah Complex,
The University of Hong Kong

Special Event:

Faculty Dinner, Friday evening – Senior Common Room, 14/F KKL

Luncheon, Friday and Saturday

Sponsored Dinner, Saturday evening – Jumbo Floating Restaurant

(All session chairs and speakers are invited to attend the dinners. Please register with Simon Wong if you have not already done so)

Participants:

An invited core group of approximately 30 experts, comprising leading academics, government policy-makers, international financial institutions officials and senior industry executives (from law firms and financial institutions), plus a selected group of bankers and lawyers from the region and students of The University of Hong Kong and other academic institutions. Total of 50-70 attendees expected.

Conference Purposes:

- (1) to serve as a launch conference for HKU's Asian Institute of International Financial Law, and
- (2) to be one of a series of high-level, international events celebrating the 30th Anniversary of the Faculty of Law of The University of Hong Kong.

Conference Objective:

International financial organizations (IFOs), e.g., the Basle Committee, IOSCO, IAIS, IASC, the Joint Forum and the Financial Stability Institute, at the request of international bodies such as the Group of Seven and the Group of Ten, have recently developed or are developing a number of principles or standards designed to present an international consensus in respect of financial regulation, principally in emerging markets. These developments have followed on the agreement of the fundamental role of the financial system in international and domestic financial stability. Given the significance of these developing standards for emerging economies worldwide, and especially in East Asia following the recent crises in the region, the conference provides a forum for presentation and discussion of these standards and for analysis of the prospects for their implementation, and more broadly for exploring the multiple legally-related aspects of the unfolding "New International Financial Architecture".

Conference Format:

A series of summary presentations of formal papers and comments, followed by group discussion.

Ongoing Programme and Global Conference Series:

The conference is designed as one aspect of an on-going programme of study at the UHK Law Faculty concerning the role international financial law and financial sector reform plays, particularly as to East Asia, in preventing financial crises and improving financial stability as we enter the 21st Century. More particularly, this conference is part of series of high-level global conferences, co-sponsored with other leading international academic institutions around the world, concerning the "new financial architecture". This series is being conducted, during 1999, in the United States, Latin America, Europe, Southern Africa and elsewhere in East Asia.

Asian Institute of International Financial Law. An Institute of the Faculty of Law of The University of Hong Kong, in cooperation with interested, expert members of HKU's School of Business, School of Economics and Finance, and Department of Real Estate and Construction, that is committed to interdisciplinary, post-graduate programmes, research, publications, conferences, short courses and seminars in the international financial law and commercial and corporate related areas, with emphases on the East Asian and Greater China areas.

Proceedings

The proceedings of the seminar (including key papers presented by distinguished academics and practitioners) will be published as a collected volume with a major, international academic publisher and selected papers may possibly comprise a "Symposium Issue" in the *Hong Kong Law Journal* and/or the Institute's Yearbook of Asian Commercial and Financial Law. Conference attendees will send advance papers/outlines by 15 May 1999. Final papers for publication should be submitted by 1 August 1999.

Conference Fees

The conference fee will be: One day - HK\$4,000, two days - HK\$6,000. Lunches and coffee are included. Dinner at additional HK\$500 each (limited places: first come first serve basis).

Professional Accreditation. 5 CPD points have been allocated for the first day of the conference and 6 CPD points for the second day.

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Conference Faculty

Mr. Douglas Arner	Sir John Lubbock Support Fund Fellow in International Capital Markets Law, CCLS (London)
Professor William Blair, QC	Visiting Professor in Banking Law, CCLS and LSE, University of London
Mr. Charles Booth	Associate Professor and Associate Dean, Faculty of Law, HKU
Professor Johannes Chan	Professor, Faculty of Law, HKU, Head of Department of Law elect, HKU
Professor Eric C. Chang	Professor of Finance and Director, Centre for Financial Innovation and Risk Management, School of Business, HKU
Professor Albert Chen	Dean, Faculty of Law, HKU
Dr Chung-Hsing Chen	CEO of Taiwan Rating Agency, Taipei and former Head of IOSCO Emerging Markets and Asian Pacific Committees
Vice-Chancellor Y.C. Cheng	Vice-Chancellor, HKU
Professor E. P. Ellinger	Emeritus Professor of Law, National University of Singapore.
Professor John Farrar	Professor of Law, Bond University, Australia
Dr. Peter Feng	Associate Professor and Co-Director, Chinese Law Group, Faculty of Law, HKU
Mr. Stefan Gannon, JP	General Counsel, Hong Kong Monetary Authority
Professor Yash Ghai	Sir Y. K. Pao Chair of Public Law, Faculty of Law, HKU
Mr. Say Goo	Associate Professor, Director, LL.M. Programme in Corporate and Financial Law, and Co-Director (designate), Asian Institute of International Financial Law, Faculty of Law, HKU
Professor Christopher H. Hanna	Professor of Tax Law and Co-Director, Centre for Pacific Rim Legal Studies, SMU School of Law (Dallas, Texas)
Ms. Betty Ho	Associate Professor, Faculty of Law, HKU
Professor Angela Itzikowitz	Professor of Law, School of Law, Wits University, South Africa
Professor Y.C. Jao	Professor of Economics, School of Economics & Finance, HKU
Professor Hideki Kanda	Professor of Law, The University of Tokyo
Mr. Hsing-fa Lin	Associate Professor, Department of Insurance Law, National Chenchi University (Taipei)

Mr. J.J. Lin	Associate Professor, Department of Insurance Law, National Chenchi University (Taipei)
Ms. Katherine Lynch	Associate Professor, Faculty of Law, HKU
Professor Roda Mushkat	Professor of Law, Faculty of Law, HKU
Professor Joseph Norton	Vice-Chancellor's Distinguished Visiting Professor of Law (HKU); Sir John Lubbock Professor of Law, University of London; and James L. Walsh Distinguished Fellow and Professor in Financial Institutions Law, SMU School of Law (Dallas, Texas)
Mr Christopher Olive	Fellow in International Financial Law, London Institute of International Banking Finance and Economic Law
Mr. George Pickering	Chief Representative, Hong Kong Representative Office, Bank for International Settlements
Mr. Andrew Procter	Executive Director, Intermediaries and Investment Products Division, Securities and Futures Commission (Hong Kong)
Professor Ian Ramsay	Professor of Law and Director, Centre for Corporate Law and Securities Regulation, Faculty of Law, The University of Melbourne
Dr Brian Semkow	Associate Professor, Department of Accounting, HKUST
Mr. Andrew Sheng	Chairman, Securities and Futures Commission (Hong Kong)
Ms. Judith Sihombing	Senior Lecturer, Faculty of Law, HKU
Mr. Philip Smart	Associate Professor, Faculty of Law, HKU
Dr. George Walker	Lecturer in UK and European Financial Law, CCLS (London)
Professor Rolf H. Weber	Professor of Business Law, Zurich University
Ms. Jane Winn	Associate Professor and Co-Director, Centre for Pacific Rim Legal Studies, SMU School of Law (Dallas)
Professor Peter Winship	James Cleo Thompson Sr. Trustee Professor of Law, SMU School of Law (Dallas)
Professor Richard Y.C. Wong	Director, School of Business, HKU
Professor Wu Ziphan	Dean, Faculty of Law, and Director, Financial Law Institute, Peking University
Mr Zhang Xian Chu	Assistant Professor, Faculty of Law, HKU

Friday Morning, 4 June 1999

Opening Session: Chair: Professor Albert Chen, Dean, Faculty of Law, HKU

- 8:30–9:00 Registration
- 9:00–9:40 **Welcome Remarks, Congratulatory Tribute on 30th Anniversary of Faculty of Law and Launch of Asian Institute of International Financial Law**
- Professor Y. C. Cheng, Vice Chancellor, HKU
 - Professor Richard Y.C. Wong, Director, School of Business, HKU
 - Professor Albert Chen, Dean, Faculty of Law, HKU
- Further congratulatory remarks from the co-sponsoring institutions**
- Professor William Blair, QC, Centre for Commercial Law Studies (CCLS), University of London
 - Dr Andreas Kellerhals, Director, Postgraduate Programme in International Business Law, University of Zurich
 - Dr Sungsoo Koh, Research Fellow, Korea Institute of Finance
 - Professor Ian Ramsay, Director, Centre for Corporate Law and Securities Regulation, The University of Melbourne
 - Professor Wu Ziphan, Dean, Faculty of Law, and Director, Financial Law Institute, Peking University

Working Session No. 1 Chair: Mr. Charles Booth, Associate Professor, Faculty of Law, HKU

- 9:40–10:15 **Keynote Remarks: “The New International Financial Architecture – Is there a Workable Solution: The Hong Kong Experience”**
- Mr. Andrew Sheng, Chairman, HKSFC
Comment: Mr. Stefan Gannon, General Counsel, HKMA
- 10:15–10:30 Questions and Answers
- 10:30–10:45 Break
- Chair: Professor Eric C. Chang, School of Business, HKU**
- 10:45–11:10 **“The New Architecture: The Legal Challenges”**
Professor Joseph J Norton, Vice-Chancellor’s Distinguished Visiting Professor of Law (HKU); Sir John Lubbock Professor of Law, University of London; and James L. Walsh Distinguished Fellow and Professor in Financial Institutions Law, SMU School of Law (Dallas, Texas)
- 11:10–11:35 **“Efficacy of Developing International Standards and the New Architecture: Of The IOSCO Process and Beyond”**
Mr. Andrew Procter, Executive Director, HKSFC
- 11:35–12:20 **“Financial Sector Reform in the PRC: The Case of Banking Regulation”**
Professor Wu Ziphan, Dean, Faculty of Law and Director, Financial Law Institute, Peking University
- “Financial Sector Reform in the PRC: The Case of Securities Regulation”**
Dr Zhang Xian Chu, Assistant Professor, Faculty of Law, HKU
- 12:20–12:30 Question and answers
- 12:30–2:00 Luncheon

Friday Afternoon, 4 June 1999

Working Session
No. 2

Chair: Professor Richard Y.C. Wong, Director, School of Business, HKU

- 2:00–2:25 **“Ongoing Challenges for Setting and Implementing International Banking Standards”**
Mr. George Pickering, Chief Representative, Hong Kong Representative Office, Bank for International Settlements
- 2:25–2:50 **“The New Architecture and Implications for Hong Kong”**
Professor Y. C. Jao, Professor of Economics, School of Economics and Finance, HKU
- 2:50–3:15 **“Global Importance of Insurance Regulatory Reform”**
Mr. Hsing-fa Lin and Mr. J.J. Lin, Department of Insurance, National Chenchi University (Taipei)
- 3:15–3:35 **“The Looming Challenges of Financial Conglomerates”**
Dr George Walker, Lecturer in UK & European Financial Law, CCLS (London)
- 3:35–3:45 Questions and answers
- 3:45–4:00 Break

Chair: Professor Johannes Chan, Professor and Head of Department of Law elect, HKU

- 4:00–4:25 **“Institutional Investors, Corporate Governance and the New International Financial Architecture”** Professor Ian Ramsay, Director, Centre for Corporate Law and Securities Regulation, The University of Melbourne
- 4:25–4:50 **“The New Architecture and Effective Corporate Governance”**
Professor John Farrar, Faculty of Law, Bond University, Australia
- 4:50–5:05 **Comment: Shareholder Remedies and Corporate Governance**
Mr. Say Goo, Associate Professor, Director, LL.M. Programme in Corporate and Financial Law, and Co-Director (designate), Asian Institute of International Financial Law, Faculty of Law, HKU
- 5:05–5:15 Questions and answers
- 5:15 .Adjourn for day
- 5:30 **Participants invited to attend special lecture in Convocation Room, Main Building by Visiting Canadian Supreme Court Madame Justice Beverley McLachlin**
- 8:00 **Chief Justice the Honourable Andrew Li to speak.**
Reception and Joint Conference Dinner, Senior Common Room, 14th Floor, KK Leung Building, HKU

Saturday Morning, 5 June 1999

Working Session
No. 3

Chair: Dr. Peter Feng, Associate Professor, Faculty of Law, HKU

- 9:00-9:25 **“Global Importance of Financial Sector Reform in Japan”**
Professor Hideki Kanda, The University of Tokyo
- 9:25-9:50 **“International Standard Setting – Implications for the Greater China Area”**
Dr Chung Hsing Chen, Taiwan Rating Agency/Standard and Poors (Taipei)
- 9:50-10:15 **“Did Hong Kong Get It Right? The Question of Government Intervention in the Stock Market”**
Katherine Lynch, Associate Professor, Faculty of Law, HKU
- 10:15-10:30 Questions and Answers
- 10:30-10:45 Break
- 10:45-11:05 **“Importance of Financial Services Sector Reform for Foreign Financial Institutions in Japan and the PRC”**
Dr. Brian Semkow, Associate Professor, HKUST Department of Accounting
- 11:05-11:25 **“Catalytic Impact of Information Technology on the New Architecture”**
Ms. Jane Winn, Associate Professor and Co-Director, Centre for Pacific Rim Legal Studies, SMU School of Law

Chair: Professor Roda Mushkat, Faculty of Law, HKU

- 11:25-11:50 **“Money Laundering”**
Professor Angela Itzikowitz, Professor of Law, School of Law, Wits University, South Africa
- 11:50-12:05 **“Regulation and Private Law Issues in Derivatives Litigation”**
Professor William Blair, QC, CCLS and LSE (London)
- 12:05-12:30 **Comment: “Derivatives and Emerging Markets”**
Mr Christopher Olive, Fellow in International Financial Law, London Institute of International Banking, Finance and Development Law
- 12:30-12:45 **Comment: “The Changing Nature of Conditionality”**
Mr. Douglas Arner, Sir John Lubbock Support Fund Fellow in International Capital Markets Law, CCLS (London)
- 12:45-1:00 Questions and answers
- 1:00-2:00 Luncheon

Saturday Afternoon, 5 June, 1999

Working Session
No. 4

Chair: Ms. Betty Ho, Associate Professor, Faculty of Law, HKU

2:00-2:25 **“Back to Basics - Interrelation of Letter of Credit Financing and Modern Financial Markets”**
Professor E. P. Ellinger, Faculty of Law, National University of Singapore.

2:25-2:50 **“An Appropriate Commercial Law Infrastructure”**
Professor Peter Winship, SMU School of Law (Dallas)

2:50-3:15 **“Effective Insolvency Reforms”**
Philip Smart, Associate Professor, Faculty of Law, HKU

3:15-3:30 Questions and Answers

3:30-3:45 Break

Chair: Ms. Judith Sihombing, Senior Lecturer, Faculty of Law, HKU

3:45-4:45 **Comments: “Responsibilities of Private Lenders”**
Dr Sungsoo Koh, Korea Institute of Finance

“Fiscal Dimensions – Selective Observations”
Professor Christopher Hanna, Professor of Tax Law and Co-Director, SMU Centre for Pacific Rim Legal Studies, SMU School of Law (Dallas)

“Financial Institution Consolidation: The Swiss Example”
Professor Rolf H. Weber, Professor of Business Law, Zurich University

4:45-5:00 Questions and Answers

Chair: Mr Say Goo, Associate Professor, Faculty of Law, HKU

5:00-5:40 Closing Comments

“A Public Lawyer’s View of Economic and Financial Reform”
Professor Yash Ghai, Sir Y. K. Pao Chair in Public Law, Faculty of Law, HKU

“The Critical Importance of the Basic Law to Hong Kong’s Economic and Financial Future”
Professor Albert Chen, Dean, Faculty of Law, HKU

5:45-6:00 **Concluding Remarks and Note on the AIIFL**
Professor Joe Norton & Mr Say Goo

6:00 Adjourn for Day

8:00 **Informal Faculty Dinner**
Jumbo Floating Restaurant (bus provided)
(Sponsored by the SMU Institute of International Banking and Finance and the London Institute of International Banking, Finance and Development Law)

The New International Architecture
Is there a workable solution?

Mr. Andrew Sheng



**The New International Architecture
Is there a workable solution?**

Andrew Sheng

Chairman

Securities and Futures Commission

**Conference on the New International Financial
Architecture**

The University of Hong Kong

4 June, 1999



Lessons of Asian Crisis

- **Lack of transparency**
- **Fragility in domestic financial systems**
- **Poor corporate governance**
- **Moral hazard through Govt guarantees**
- **Volatile capital flows**
- **Highly leveraged institutions**
- **Problems in macro-economic management**
- **Poor risk management**



Present Financial Architecture New crisis - old fire engines

- **Multilateral agencies: -**
 - ❖ IMF - Interim Committee
 - ❖ World Bank - Development Committee
 - ❖ BIS - Central banks
 - ❖ OECD - Industrial economies
- **Regulatory bodies: -**
 - ❖ Basle Committee on Banking Supervision, IOSCO, IAIS, IASC
- **Policy Groups - G7, G-10, G-22**
- **National Authorities**



G-22 Process - 3 Working Groups

- **Transparency & Accountability**
 - ❖ Promote international standards of accounting & disclosure
 - ❖ Upgrade national statistics & transparency
 - ❖ Recommends Transparency Report
- **Strengthening Financial Systems**
 - ❖ Urges implementation of existing set of regulatory standards
 - ❖ Develop corporate governance standards
 - ❖ Urges Financial Sector Policy Forum
- **International Financial Crises**



G-22 Working Group on International Financial Crises

- **Policies to reduce frequency and limit the severity of financial crisis**
 - ❖ Reduce Government guarantees
 - ❖ Arrange innovative market funding
- **Policies to encourage credit coordination**
 - ❖ Adoption of “collective action clauses”
- **Promoting Orderly, Co-operative & Equitable Crisis Resolution**
 - ❖ Strengthen IMF resources
 - ❖ Development private sector sources of funding
 - ❖ Encourage orderly workouts



Elements of New International Financial Architecture

- **Transparency**
- **Crisis Prevention**
 - ❖ IMF Contingency Credit Lines
 - ❖ Orderly workout of crisis - collective negotiation clauses in bond contracts & definition of payout arrangements
- **Freedom of capital flows - sequenced liberalization**
- **Global standards and codes of good practice**



Trends in Financial Environment - Andrew Crockett

- **Securitisation**
 - ❖ Increased trade in derivatives & OTC
- **Market integration**
 - ❖ EU, NAFTA, Asian market
- **Intensified competition**
 - ❖ Internet trading, loss in protected franchises, higher risks
- **Globalization**
 - ❖ 24-hour trading reality



Functions of Financial Markets

- **Allocation of real resources - exchange of property rights**
- **Provision of choice in timing of consumption - saving or consumption**
- **Risk management - enable diversification of risks**
- **Role in corporate governance**
- **Provision of information - price discovery and valuation of property rights**



Financial Stability Forum

- **Coordinating forum for key policy authorities and IFIs**
- **Comprise national authorities + BIS, IBRD, IMF, OECD, IOSCO, IIS, Basle Committee**
- **Mandate**
 - ❖ Assessing vulnerabilities in the global financial system
 - ❖ Identifying and overseeing action to address these vulnerabilities
 - ❖ Improving coordination & information exchange



FSF - Highly Leveraged Institutions (HLIs)

- High leverage increases volatility in markets
- Imposes two types of risks
 - **Concentration risk**
 - **Market monopolistic power**
- Lack of transparency of operations does not enable counterparties to appreciate their total credit and market risk exposure, thus putting public-guaranteed bank deposit funds at risk
- “Elephant in the pond” problem - HLIs can leverage themselves through derivatives and potentially can collude to manipulate smaller emerging markets



FSF - Offshore Centres

- **Funds increasingly move offshore for**
 - Tax arbitrage
 - Regulatory arbitrage
 - Secrecy
- **Global gain, but local pain**
 - Benefits of globalization escape regulatory and tax net
 - Costs of crisis are borne by local economies without ability to tax resources moved offshore
- **Offshore centres should not harbour international crime and market misconduct, e.g. money laundering**



Political Economy of Financial Crisis Who Pays?

- **Borrowers - bankruptcy**
- **Investors/creditors - haircuts and write-offs**
- **Domestic Depositors - bank bankruptcy**
- **Domestic taxpayer - future taxation**
- **Consumers - inflation tax**
- **Trading partners - devaluation**
- **Multilateral assistance - IFIs**
- **Bilateral assistance**
- **Global taxation - Tobin Tax**



Global Markets - National Rules

- **Differences in Standards, Codes of Practice, Rules and Regulations and Laws**
- **Differences in Interpretation, Adjudication, Enforcement and Due Process**
- **Need for convergence**
 - ❖ Consensus building
 - ❖ Timing of convergence
 - ❖ Process of conflict resolution
 - ❖ Dealing with gaps



Challenges in International Co-operation

- **Consistency in regulation and supervision**
- **Information**
- **Incentives**
- **Systemic interactions**
- **Monitoring and surveillance**
- **Sound macro-economic environment**
- **Need for intensified co-operation and coordination**



Transparency & Accountability

- **Gap in disclosure**
- **Gap in incentives to use information**
- **Gap in GAAP**
 - ❖ Should we use US GAAP or IAS
- **Gap in capacity to understand information**
 - ❖ Urgent need to raise emerging market awareness of risks and full implications of globalization



Political Economy in New Architecture

- **Who sets the standards & rules**
- **Who implements these rules**
- **Who enforces these rules**
- **Who interprets the rules**
- **Who adjudicates these rules**



Democracy of Markets No Taxation without Representation

- **Who decides architecture?**
- **Voting power by**
 - ❖ Population? - emerging markets
 - ❖ GDP? - G10
 - ❖ Transactions Volume - G-3
 - ❖ Market Capitalization - G-3



Financial Markets as Networks

- **Networks have positive and negative externalities**
- **Power surges can cause weak hubs to trip fuse**
- **Stability and resilience of global network only as good as domestic networks**
- **Hence, charity begins at home**
 - ❖ Need to build strong fundamentals
 - ❖ Fair, efficient and transparent markets, with sound regulation to international standards
 - ❖ Global competition - no one is immune



Competing in Global Markets

- **Competition and productivity comes from**
 - ❖ Improvements in computer and telecommunications technology
 - ❖ Revolution in management attitudes, incentives and processes - only the paranoid survive
- **Internet technology undercuts intermediation and traditional franchises**
- **Consumer sophistication requires better quality products, services, content, convenience, immediacy and lower costs**
- **Devaluation worsens competition**



Alice Rivlin: Globalized domestic markets need:

- **Flexibility and adaptability of businesses, workers and communities**
- **Willingness of workers to learn new skills, take risks and move to new jobs and places**
- **Nimbleness, flexibility and risk taking on part of businesses**
- **Communities to be adaptable, diversify economic bases, attract new jobs and residents**
- **Governments to be imaginative to design transition assistance for workers and communities to change and adapt**

**The New International Financial
Architecture: The Legal Challenges**

Professor Joseph J. Norton

ESSAYS IN INTERNATIONAL FINANCIAL & ECONOMIC LAW

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“The global financial system has been evolving rapidly in recent years. New technology has radically reduced the costs of borrowing and lending across national borders, facilitating the development of new instruments and drawing in new players. One result has been a massive increase in capital flows... This burgeoning global system has been demonstrated to be a highly efficient structure that has significantly facilitated cross-border trade in goods and services and, accordingly, has made a substantial contribution to standards of living world-wide. Its efficiency exposes and punishes underlying economic weaknesses swiftly and decisively. Regrettably, it also appears to have facilitated the transmission of financial disturbances far more effectively than ever before.”¹

“Small open economies are like rowing boats on an open sea. One cannot predict when they might capsize; bad steering increases the chances of disaster and a leaky boat makes it inevitable. But their chances of being broadsided by a wave are significant no matter how well they are steered and no matter how seaworthy they are.”²

I. INTRODUCTION

There is general agreement that the initial onset of the East Asian Financial crisis was made possible by fundamental economic, political and financial market errors and weaknesses, but also that the market reaction to these vulnerabilities (as their extent was revealed) was exaggerated and disproportionate.³ This is based on a model of “self-fulfilling” crises, under which existing vulnerabilities make a crisis a possibility but not a certainty. Unfortunately, the analyses to date (whether from public or private, domestic or international sources) do not suggest at what point underlying

¹ A. Greenspan, Testimony of Chairman Alan Greenspan Before the Committee on Banking and Financial Services, US House of Representatives, 30 Jan. 1998.

² J. Stiglitz, “Boats, Planes and Capital Flows”, *Fin'l Times*, 25 Mar. 1998.

³ The best explanation of this viewpoint is that of Charles Wyplosz of the Graduate Institute of International Studies, Geneva, and the Centre for Economic Policy Research in London. See C. Wyplosz, “Globalised Financial Markets and Financial Crises”, conference paper for “Coping with Financial Crises in Developing and Transition Countries: Regulatory and Supervisory Challenges in a New Era of Global Finance”, Forum on Debt and Development, Amsterdam (16-17 Mar. 1998) (available at <http://heiwwww.unige.ch/~wyplosz/fondad.pdf>). See also R. Dornbusch, “Asian Crisis Themes”, mimeo (Feb. 1998) (available at <http://web.mit.edu/rudi/www/asianc.htm>).

vulnerabilities will move from being the potential for a crisis and the point at which a crisis is a certainty.

In this vein, according to Alan Greenspan, Chairman of the US Federal Reserve Board, once the crisis was triggered by Thailand's forced abandonment of its exchange rate peg, it was apparently the combination of pegged exchange rates, high leverage ratios, weak banking and financial systems, declining demand in Thailand and elsewhere, and increased competition from countries such as China and India that transformed a correction into a collapse.⁴

All this has been so painful for those involved countries; and this article will not belabour upon the immediacies of the most unfortunate events, particularly, as my colleague, Mr. Arner, will be considering the specific bailout packages. This article prefers to look to the future to see what emerging economies should be doing prospectively and over the long-term to help ensure sound economic, political and financial markets fundamentals are in place in order to avoid or (at least) to minimise the effects of a future crisis.

This article suggests that in the face of potential self-fulfilling crises, countries should act in advance (*i.e.*, to take pre-emptive action) to reduce their potential vulnerabilities, both to an initial crisis and to contagion resulting from the onset of a crisis elsewhere, whether through panic, fundamental problems or the unpredictable potentialities of vulnerabilities. In effect, a main emphasis of this presentation concerns the importance of ongoing and meaningful ("bottom-up") economic, financial and commercial law reform throughout the East Asian region (or other emerging regions) and the related enhancement of legal education in these subject matter areas. In this sense, this article suggests, further that, in looking forward, these emerging countries needs to consider the critical importance of a law-based, "building block" approach in addressing the long-term implications of the current East Asian financial crises.

A law-based approach invariably will entail a broad rule-oriented framework where unfettered discretion, non-transparency and cronyism must give way. But not only should such a framework be broad in its scope, it should be deep in its implementation. As such a comprehensive and co-ordinated framework will need to entail and to interconnect the legislative, administrative, supervisory, examination, enforcement and judicial administration processes of the country.

Yet, this law-based approach to the economic regulation of the financial sector is not simply about laws and legal processes: law is merely one societal *means* to achieving and legitimising appropriate policy objectives. In the area of financial sector reform, this article suggests that a law-based approach must also be an interdisciplinary approach, where law is the thread that weaves together economic, political and social objectives with a transparent and fair

⁴ Greenspan Testimony 30 Jan, *op. cit.*, n 1.

implementation process and where the lawyers should work closely with the economists, policymakers, operational people and the accountants.

The commitment to a law-based financial sector reform programme must be a *long-term societal commitment* whereby the notion of a process based upon a “*rule of law*” becomes ingrained within and throughout the fabric of civil, political and economic societies in emerging economies, in a substantive manner and not merely as a façade.

To achieve and to sustain this long-term commitment will depend, in large part, on the development of a strong and vibrant educational infrastructure involving new university educational approaches to the teaching of financial law-related subjects on an interdisciplinary basis, and to new approaches to bureaucratic and judicial training. In a sense a new “partnership” needs to be forged among the academic, bureaucratic, judicial and practical business and financial worlds in order to ensure that this interdisciplinary educational infrastructure comes into being and becomes an integral part of the overall financial sector reform process- a process that embodies not simply an enactment stage, but an effective administrative implementation stage, an effective administrative and judicial enforcement stage, and meaningful monitoring and readjustment mechanisms. –Here key governmental bureaucracies having interdisciplinary components and leading Universities having strong Law, Economic and Accounting Faculties can play most constructive and catalytic roles.

Rather than looking in detail at the factual background to the crisis in Asia, this article instead will focus on the main vulnerabilities that caused or exacerbated the crisis and will suggest what the affected individual countries might do to reduce not only their own vulnerability to crisis but also to the possible contagion from crisis elsewhere. In addition, while there is at present extensive debate taking place about the role of the “architecture of the international financial system”⁵ in both preventing and responding to crises, the focus of this article will not be on the international financial system, but rather on the legal and economic policies of individual countries within that system.

Also, this article will refrain from “pointing fingers” or “second-guessing”. Hindsight is indeed a luxury for academics and “armchair” politicians. Clearly, in looking back, one might have taken different decisions, whether it be with respect to the sequencing of the liberalisation process, the introduction of a “managed float” at an appropriate stage, an earlier concentration on

⁵ See, e.g., M. Camdessus (IMF Managing Director), “From the Asian Crisis Toward a New Global Architecture”, address to the Parliamentary Assembly of the Council of Europe, Strasbourg, France, 23 June 1998; and “The Role of the IMF: Past, Present, and Future”, Remarks by Michel Camdessus, remarks at the Annual Meeting of the Bretton Woods Committee, Washington, D. C., 13 Feb. 1998, IMF Speech 98/4 (both available at www.imf.org).

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developing a suitable bond market, or the avoidance of questionable governmental forward exchange contract practices. But, at the end of the day, no one (except perhaps a few private analysts) had it right – not the International Monetary Fund (IMF), not the Asian Development Bank (ADB) and, not the U.S. Treasury; and, certainly no one (inside or outside government) foresaw the disproportionate market reaction and ensuing contagion. – Lessons, indeed, need to be learned from past practices and policies – but prolonged self-flagellation has limited therapeutic value. All responsible parties should be looking to the future in seeing that the affected countries develop and sustain a strong and robust financial sector, with true integrity and transparency.

II. CERTAIN SIGNIFICANT UNDERLYING VULNERABILITIES

The underlying vulnerabilities of the East Asian Crises resulted, in large part, from a *combination* of macroeconomic imbalances, weak financial institutions, widespread corruption, political instability or uncertainties, moral hazard problems, improper sequencing in the liberalisation process and inadequate legal foundations in each of the affected countries. This section will touch upon, in a preliminary manner, the latter three-mentioned vulnerabilities (the other factors will be dealt with in a more integrated way in Part III).

A. Moral Hazard and the Role of the Banking System

Most analyses agree on a fundamental role of the banking system in explaining both the East Asian crises and the earlier Mexican crisis. This line of reasoning suggests that a significant problem in these cases was excessive bank lending following financial market liberalisation. Domestic banking crises are common in developing countries for a variety of reasons; often they are the result of bad lending practices, exacerbated by political influences on bank lending or actual policy lending to state owned enterprises or politically favoured enterprises, and, in many cases, as underpinned by corrupt or questionable and non-transparent business practices. These problems are further exacerbated when banks' primary source of funds is borrowing in an unhedged foreign currency, because in the event of currency pressures, domestic on-loans go into default, worsening domestic lenders' balance sheets as their own currency position worsens due to external unhedged borrowing. Given investor overreaction leading to denial of roll-over treatment for existing debts, a domestic crisis quickly takes on regional and even

international proportions. Importantly, all of these problems are worsened by a financial system that is fragile, and poorly regulated and supervised.

It has long been realised that financial intermediaries whose liabilities are guaranteed by the government pose a serious problem of moral hazard: the US savings and loan debacle being the classic example.⁶ The case in East Asia, however, is more murky because creditors of financial institutions did not receive explicit guarantees, but rather perceived that they would be protected from risk due to implicit guarantees, enforced by the politicisation of the financial system. In any event, institutions believe that because of political connections or pressures they will not be allowed to fail, this may plant the seeds for excessive financial risk-taking and eventual bad debt problems.⁷

As to the issue of the existence of a deposit insurance scheme and moral hazard, it should be noted that a country such as Thailand is in the active process of developing a deposit insurance scheme. In this author's view, a properly constructed and implemented deposit insurance scheme, on balance, bring more benefits of system confidence than system risks to a banking system. Such a system should be a "risk-based one", funded by the banking sector, and should be of limited amount, and should not be a 100% insurance guarantee for all depositors.

B. Improper Sequencing of Liberalisation

Analysis suggests that financial market liberalisation may be the best predictor of financial crisis: this has been true in Latin America and the US in the 1980s, in Europe in the early 1990s, in Mexico in 1994 and in Asia in 1997.⁸ In East Asia, financial liberalisation lifted some restrictions before putting in place a sound regulatory framework.⁹

In terms of self-fulfilling crises, financial liberalisation makes attacks possible and exposes underlying vulnerabilities to the vagaries of international capital markets; this tension between market liberalisation and system stability and safety and soundness needs to be better understood and appreciated by all. The lesson is that financial liberalisation should be contemplated only when the situation is ripe. First, significant financial weaknesses, such as banking system weaknesses, large external debt, high unemployment and unsettled macroeconomic conditions, must be eliminated. Second, countries which

⁶ P. Krugman, "What happened to Asia?" mimeo (Jan. 1998) (available at <http://web.mit.edu/krugman/www/DISINTER.html>). For a detailed discussion, see G.N.Olson, *Banks in Distress: Misdirection in Public Policy and Law* (forthcoming 1998).

⁷ For discussion of these moral hazard situations arising with the Thailand context, see the article by T. Traisorat, "The Thai Crisis of 1997-98: An Opportunity to Re-address the Fundamentals," in upcoming *Thammasat University Law Journal*.

⁸ See Wyplocz, *op. cit.*, n 23, at pp. 2, 10-11.

⁹ See J. Stiglitz, "Bad Private-Sector Decisions", *Wall St. J.*, 4 Feb. 1998.

accept full capital mobility must sacrifice either fixed exchange rates or monetary policy independence. Monetary policy independence requires a reasonably flexible exchange rate, while a tight exchange rate requires the abandonment of monetary policy independence, for instance through a currency board arrangement. Full capital liberalisation should be the last step of this process.

C. Political Instability and Uncertainty

As in Mexico, perceptions of political uncertainty and instability were very significant causes of the initial confidence crisis among external investors in East Asia. Much as in Mexico, perceptions throughout 1997 of the weakness and inability of the Thai government to deal with underlying economic problems, uncertainty during this period over the physical and political health of then President Suharto in Indonesia and the December 1997 elections in South Korea caused investors to question the political stability of the three countries which eventually required bailouts. While countries such as Malaysia and the Philippines were also badly effected, their perceived levels of political stability were viewed much more favourably than in the bailout candidates. Political problems also impeded the implementation of appropriate political responses to the impending and developing financial problems, most especially in Indonesia. While the initial responses in Thailand and South Korea were the occasion of much uncertainty, the situation was quickly taken in hand and perceptions of political stability and eventual successful reform yielded rapid benefits, giving hope for a rapid turn around, as had in fact occurred in Mexico in 1996-97 (but, which has become fragile again in 1998). Indonesia's continued vacillation and political turmoil has undermined perceptions of its economic situation.

A lesson from the East Asian and Mexican financial crises is that countries with weak and indecisive governments and institutions in conjunction with other underlying vulnerabilities are more likely to suffer external or internal confidence crises than those with perceived strong and decisive governments and capable institutions. Further, such governments and institutions have the potential to severely worsen the effect of any crisis or contagion through their ineptitude and inability to demonstrate firm and clear policy commitments. The case of Indonesia is inescapable; moreover, the lessons for Russia, among others, are clear. In this regard, Thailand failed to appreciate fully that international perceptions of political instability (e.g., fractious coalition governments with repeated changes in Finance Ministers and Governors of the Bank of Thailand) in fact weakened international confidence and increased vulnerability to international capital withdrawal. Korea with a regretfully perceived pending change in government also led to considerable political uncertainty during the critical incipient period of its financial crisis.

III. WITHSTANDING FUTURE CRISES: MOVING TOWARD A LAW-BASED APPROACH

The collective interconnection of major developing countries into the international financial system implies that disturbances in any other market, whether developed or developing, can be rapidly translated in the form of financial contagion into developed or developing markets. Empirical investigations by the IMF and other international organisations have confirmed that the increase in cross-border capital flows over the past ten years, most notably through portfolio investment, has bound national capital markets more closely together and that the cross-border translation of disturbances can occur with unnerving speed. This concept was reinforced by the ensuing contagion from the Mexican and East Asian crises extending to other countries in the region and world-wide, as most countries in these regions, even those with fundamentally sound economic indicators, experienced temporary exchange and equity market disturbances during the respective crises.¹⁰

According to Alan Greenspan, vicious crisis cycles such as that in Mexico in 1994 and Asia in 1997-98 may in fact be "a defining characteristic" of today's high-tech international financial system.¹¹ As a result, while human panic reactions may not be controllable, at least the imbalances that exacerbate them can be addressed, preferably in advance.

According to Stanley Fischer, First Deputy Managing Director of the IMF, in order to avoid crises, a country needs both sound macroeconomic policies *and* a strong financial system.¹² A sound macroeconomic policy framework is one that promotes growth by keeping inflation low, the budget deficit small, and the current account sustainable. This is traditional IMF fare, and is reflected in the IMF's most recent Article IV consultation.¹³ Unfortunately, what became apparent all too readily with the unfolding of the East Asian financial crises, is that the IMF had no "magic formula", that earlier IMF experiences with Central and Eastern Europe and Mexico were not readily transportable to East Asia; that there could be no model approach for all troubled East Asian countries; and that the "jury is still out" on whether history will judge the IMF approach on East Asia as a curative foundation for

¹⁰ See IMF, *International Capital Markets: Developments, Prospects and Key Policy Issues* (Nov. 1997); *idem.*, *International Capital Markets* (Aug. 1995), *op. cit.*, n 13.

¹¹ Greenspan Testimony 30 Jan., *op. cit.*, n 1.

¹² S. Fischer, "How to Avoid International Financial Crises and the Role of the International

Monetary Fund", 15th Annual Cato Institute Monetary Conference, October 14, 1997, Washington D.C., 14 Oct. 1997 (available at <http://www.imf.org/external/np/speeches/1997/101497.htm>).

¹³ See, e.g., IMF, "IMF Concludes Article IV Consultation with Thailand", IMF Press Information Notice No.98/44, 25 June 1998.

recovery or as an exacerbating factor for further economic recession/depression in the region.

However, the focus on the importance of a country's financial system is a more relative development. The critical role of the strength of the financial system was becoming clear before the Mexican crisis; it was crystal clear in that crisis and its aftermath; and it has been equally clear in the East Asian crises and their aftermath. In this respect, Greenspan notes eight factors that have been present in international and economic disruptions, but which appear in more stark relief today, namely¹⁴: excessive leverage¹⁵; interest rate and currency risk¹⁶; weak banking systems¹⁷; interbank funding, especially in foreign currencies¹⁸; moral hazard¹⁹; weak central banks²⁰; underdeveloped securities markets²¹; and inadequate legal structures.²² This author would

¹⁴ Greenspan Testimony 30 Jan., *op. cit.*, n 1.

¹⁵ Exceptionally high leverage is often a symptom of excessive risk-taking that leaves financial systems and economies vulnerable to loss of confidence. This concern is particularly relevant to banks and other financial intermediaries, whose assets typically are less liquid than their liabilities and so depend on confidence in the payment of liabilities for their continued viability. Further, excessive leverage can create problems for lenders that can in turn spread to other borrowers that rely on those lenders. This is particularly the case in Korea and in Japan. *Ibid.*

¹⁶ Banks, because of their nature, lend long and fund short, thereby incurring interest rate or liquidity risk. This exposes them to shocks, especially those institutions with low capital-asset ratios. These problems are exacerbated when financial intermediaries borrow in unhedged foreign currency, with the result of potential bank runs following the collapse of the domestic currency. *Ibid.*

¹⁷ When banks are undercapitalised, have lax lending standards, and are subject to weak supervision and regulation, they become a source of systemic risk, both domestically and internationally. *Ibid.*

¹⁸ Despite its importance for distributing savings to their most valued use, short-term interbank funding, especially cross-border, may turn out to be the "Achilles' heel" of an international financial system that is subject to wide variations in confidence. *Ibid.*

¹⁹ The expectation that monetary authorities or international financial institutions will come to the rescue of failing financial systems and unsound investments has clearly engendered a significant element of moral hazard and excessive risk-taking. Further, the dividing line between public and private liabilities too often becomes blurred. Interest and currency risk-taking, excessive leverage, weak financial systems, and inappropriate interbank funding are all encouraged by the existence of an excessive safety net (e.g. US S&L crisis) or perceptions of the existence of an excessive safety net (e.g. East Asia). *Ibid.*

²⁰ To effectively support a stable currency, central banks need to be independent, i.e. their monetary policy decisions are not subject to the dictates of political authorities. *Ibid.*

²¹ Recent adverse banking experiences have emphasised the problems that can arise if banks are almost the sole source of financial intermediation. Their breakdown induces a sharp weakening in economic growth. Therefore, a wider range of non-bank

suggest that in fact all of these problems are “law-based failures” and should be addressed, to a significant degree, within that context.

A. Law Reform and Financial Stability

Consistent with the notion of “law-based failures”, scholars, governments, international institutions and businesses now recognise that one of the most important aspects of economic growth for any economy is financial stability,²³ and that financial stability is based on the underlying legal and financial infrastructure in an economy. For the first time, an international consensus is developing on exactly what is necessary in the way of legal and financial infrastructure for financial stability.²⁴ The consensus in this area is that in order to develop economically, emerging markets must have in place appropriate structures to guarantee financial stability, especially given the increasing mobility of international capital and the reliance of emerging markets on that capital to fund their own development processes. Further, as Japan is experiencing today, an effective financial infrastructure is as necessary to a developed economy as to an emerging economy, such as Thailand, although as both Thailand and Mexico have experienced, it can be less precipitous for a developed economy to extricate itself from problems than for an emerging economy.

In developing financial stability and the requisite legal infrastructure, four issues seem to be paramount: (i) a robust financial system, including an independent central bank; (ii) corporate governance and the creation of an effective incentive and monitoring structure for corporate performance; (iii) strengthening and expanding domestic capital markets; and (iv) the need for an effective insolvency regime combined with the creation of a social safety net, in order to resolve businesses and prevent political and social instability.

institutions, including viable debt and equity markets, are important safeguards of economic activity when banking fails. *Ibid*

²² An effective competitive market system requires a rule of law that severely delimits government’s arbitrary intrusion into commercial disputes. While defaults and restructuring are in some circumstances unavoidable and in fact a beneficial element of renewal in a market economy, an efficient bankruptcy statute is required to aid in this process, including in the case of cross-border defaults. *Ibid*

²³ This consensus was recently detailed in the Report of the Group of Ten (G-10) Working Party on Financial Stability in Emerging Markets, *Financial Stability in Emerging Market Economies: A Strategy for the Formulation, Adoption and Implementation of Sound Principles and Practices to Strengthen Financial Systems* (April 1997) (available at <http://www.bis.org>).

²⁴ These ideas are being increasingly formalised: see IMF, *Financial Stability in Emerging Markets* (Dec. 1997).

1. *Building Robust Financial System*

Experience has shown that a robust financial system is one of the most important components of successful and sustainable development. A robust financial system allows a country to mobilise domestic savings and international finance and to channel these resources to productive, growth-enhancing investments.²⁵ Further, the existence of an independent central bank enables a country to have pre-determined and credible objectives underlying financial stability.²⁶ The efforts of a central bank to maintain an independent and objective posture throughout the crisis must prevail even in the face of difficult domestic and international pressures: the ultimate goal is for the central bank to be perceived as a capable and independent political entity, thus strengthening external confidence in the future of the country's sustainable economic development.

Many of the elements required for building robust financial systems are now understood. In response to an initiative at the Lyon summit of the Group of Seven (G-7) in June 1996, representatives of the countries in the Group of Ten (G-10) and of emerging market economies have jointly sought to develop a strategy for fostering financial stability in countries experiencing rapid economic growth and undergoing substantial changes in their financial systems.²⁷ In their Report, the G-10 focused on three key elements necessary to the development of a robust financial system: (1) creation of an institutional setting and financial infrastructure necessary for a sound credit culture and effective market functioning; (2) promotion of the functioning of markets so that owners, directors, investors and other actual and potential stakeholders exercise adequate discipline over financial institutions; and (3) creation of regulatory and supervisory arrangements that complement and support the operation of market discipline.²⁸ The creation of an independent central bank with clearly defined objectives should be added to this list.

Importantly, given that a safe and efficient financial system is essential for the functioning of any economy, the G-7 at their Lyon Summit in 1996, in the wake of the Mexican Peso Crisis of 1994-95, directed the international financial institutions, especially the IMF, the World Bank and the Basle Committee on Banking Supervision, to develop standards for financial regulation to be implemented in both developed and developing countries, as well as to develop solutions for domestic crises with international implications, such as the Mexican Crisis.²⁹

As a result, the international financial organisations (IFOs) have been producing standards in a number of areas: the Basle Committee on Banking

²⁵ See, *inter alia*, E.P. Davis, *Debt, Financial Fragility and Systemic Risk* (1995).

²⁶ See generally, R. Lastra, *Central Banking and Banking Regulation* (1996).

²⁷ See G-10 Report, *op. cit.*, n 50, p. 1.

²⁸ *Ibid.*, pp. 3-4.

²⁹ *Ibid.*, p. 49.

Supervision (Basle Committee) published its *Core Principles for Effective Banking Supervision* (recently finalised)³⁰; the International Association of Insurance Supervisors (IAIS) published supervisory principles in September 1997³¹; the International Organisation of Securities Commissions (IOSCO) will soon present securities principles³²; and the International Accounting Standards Committee (IASC) will present a comprehensive set of international accounting standards to the membership of IOSCO for approval in July of this year.³³ In addition, the Joint Forum on Financial Conglomerates (a co-operative effort of the Basle Committee, IOSCO and the IAIS) is also to produce some sort of "principles" document.³⁴

A number of the East Asian and other emerging and transitioning economies have been actively involved in all of these international efforts and are endeavouring to duly implement the resulting consensus in its domestic financial system. This should not only increase external confidence in a

³⁰ Basle Committee on Banking Supervision, *Core Principles for Effective Banking Supervision* (Sept. 1997). See generally the BIS website for further information at <http://www.bis.org>.

³¹ Information concerning the IAIS can be found at <http://www.naic.org/otherinf/iais/iaistoc.htm>.

³² Information concerning IOSCO and its available documents can be found at its Internet homepage at <http://www.iosco.org>.

³³ See IOSCO, *Annual Report 1996*. See also the website of the IASC at <http://www.iasc.org.uk>.

³⁴ According to a recent BIS Press Release:

The Joint Forum on Financial Conglomerates (Joint Forum) was established in early 1996 under the aegis of the Basle Committee on Banking Supervision (Basle Committee), the International Organisation of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS) to take forward the work of the Tripartite Group whose report was released in July 1995. The Joint Forum is comprised of an equal number of senior bank, insurance and securities supervisors representing each supervisory constituency. Thirteen countries are represented in the Joint Forum: Australia, Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Spain, Sweden, Switzerland, United Kingdom and United States. The EU Commission is attending in an observer capacity. In accordance with its mandate which was agreed by the Basle Committee, IOSCO and the IAIS (collectively "the parent organisations"), the Joint Forum has reviewed various means to facilitate the exchange of information between supervisors within their own sectors and between supervisors in different sectors and has investigated legal or other barriers which could impede the exchange of information between supervisors within their own sectors and between supervisors in different sectors. Also, based on its mandate, the Joint Forum has examined ways to enhance supervisory co-ordination, including the benefits and drawbacks to establishing criteria to identify and define the responsibilities of a co-ordinator, and is working on developing principles toward the more effective supervision of regulated firms within financial conglomerates.

Basle Committee, *Press Release: Supervision of Financial Conglomerates* (Feb. 1998) (available at <http://www.bis.org>).

country's financial system, but also gives the country a valuable regional role and voice in the on-going debates on these issues. It is important to take into account these international developments as one methodology for the establishment of an internationally accepted "floor" for domestic and regional efforts aimed at development, increased market access within the region and eventually internationally. But, the real test is how to translate effectively these standards into individual domestic systems.

a. Effective banking regulation and supervision. Recent work by the Basle Committee (composed of the G-10 central bank governors) and others has shown that one of the most prevalent problems in any emerging economy is effective regulation and supervision of the banking system. In essence, the goal is the combination of strong incentives for prudential behaviour with an effective regulatory system.³⁵ Incentives are provided through capital requirements and franchise value, *i.e.*, the value of future profits; while regulation should focus on every level of financial activity, from risk management to individual transactions.

While of fundamental importance, capital adequacy has to be judged on the basis of the risk characteristics relevant to banks in each country and the Basle risk-based capital adequacy standards must be taken as guides or minimums, and certainly not as a maximum of capital adequacy irrespective of country-specific factors.³⁶ In addition, supervision and regulation should address excess non-performing loans expeditiously.³⁷

The Basle Core Principles present the basic outline for effective banking supervision and are intended to serve as a basic reference for supervisory and other public authorities in all countries and internationally. Essentially, the Basle Committee has prepared a list of twenty-five basic principles that should underlie the banking supervisory policies and structures. These principles are then enumerated in a *Compendium* of existing Basle Committee documents which are cross-referenced in the Core Principles and are intended to expand upon them and explain their application and are to be periodically updated, as additional documents are released.³⁸

³⁵ See J. Stiglitz, Statement to the Meeting of Finance Ministers of ASEAN plus 6 with the IMF and the World Bank by Joseph Stiglitz, Senior Vice President and Chief Economist, The World Bank, Kuala Lumpur, Malaysia, 1 Dec. 1997 (available at <http://www.worldbank.org/html/extdr/extme/jssp120197.htm>).

³⁶ T.N. Srinivasan, "Comments on Jeff Sach's presentation in the session Emerging Market and Financial Crises, USAID Economic Growth Training Workshop, Leesburg, Va., 29 Sept-3 Oct. 1997 (available at <http://www.stern.nyu.edu/m.noroubin/asia/SACHS.pdf>).

³⁷ Greenspan Testimony 30 Jan., *op. cit.*, n 1.

³⁸ Basle Committee on Banking Supervisions, *Compendium of Documents Produced by the Basle Committee on Banking Supervision* (April 1997) (updated).

In terms of the twenty-five Core Principles themselves, they are divided into seven sections: preconditions for effective banking supervision (Principle 1), licensing and structure (Principles 2 to 5), prudential regulations and requirements (Principles 6 to 15), methods of ongoing banking supervision (Principles 16 to 20), information requirements (Principle 21), formal powers of supervisors (Principle 22), and cross-border banking (Principles 23 to 25). While these Principles are very instructive in terms of coverage and issues, they nonetheless must be implemented by domestic authorities individually.

In terms of basic structural issues, there are three that appear to be of the most significance, and these need to be addressed each in turn. First, decision-makers must address the question of whether banking supervision should be placed under the ambit of the central bank. Second, given the increasing trend internationally towards universal banking, the question is whether regulation of banks should be taken from an institutional or a functional basis. Third, decision-makers must address the issues which arise from the increasing prominence of financial conglomerates, and the regulatory structural questions that these issues raise, namely whether a single financial regulatory scheme is a logical step in an evolution of regulatory approaches. As to this latter issue, there is a significant split in views as to whether supervision should be separated from the Central Bank (as with the case of new UK Financial Services Authority or the Mexican super-regulator situation) or whether, economic and protocol efficiencies favour a joint role for the Central Bank (also, half-way positions are possible, as with the Australian Wallis Committee proposal; as are mixed positions as with the U.S. Federal Reserve System and linked positions as with Germany). This author's own view is that there is no one set answer; and that until financial markets are at a well developed stage and universal and conglomerate financial services are prevailing within an emerging economy, most emerging economies would be best to leave supervision with the Central Bank. In all events, each of these three decisions requires complex analysis, from both a political and a legal standpoint, in order to assure that domestic goals are adequately addressed.

As a side note, this author makes note of the somewhat unorthodox structural, bank regulatory approach of a country such as Thailand, where supervision is bureaucratically separated from the examination process and each of these from the enforcement process. If this trifurcated approach is the preferred Thai way, then, at minimum, a close co-operation and information sharing and review mechanism among these three departments should be in place under the general oversight of the Bank of Thailand's Board of Governors.

b. Lending infrastructure, corporate governance and hedging markets. Beyond the various emerging "Core Principles", recent studies have suggested a number of factors that are of importance in the development of a stable and

effective banking system. Of special importance are the development of adequate lending infrastructure, effective corporate governance for banks and access to derivatives markets.³⁹

First, an adequate lending infrastructure is based on the problem of mismatches between bank lending and borrowing ("duration"). An adequate lending infrastructure essentially enables banks to extend the time horizon of their loans through greater security. In this regard, two aspects of lending infrastructure are especially important: an effective system for taking security and the development of credit rating systems and/or agencies. An effective system for the taking of security allows banks to be more confident that they will be able to realise collateral taken on loans.⁴⁰ Providing a system of registering and taking security therefore provides two functions for bankers: first, it allows them to reduce monitoring costs because their investment is protected; and second, it provides greater certainty in making lending decisions, thereby increasing the number of such decisions that will be made. The development of credit rating systems and agencies serves similar functions in that they decrease the need for initial research and subsequent monitoring, thereby reducing the cost of credit and increasing lending and loan maturities.

Second, effective corporate governance for banks is necessary to avoid the sorts of problems faced by the US during the S&L crisis of the 1980s. Banks must be adequately capitalised so that their investors have incentives to protect their own investments by making careful borrowing and lending decisions. As an aspect of this, banks must know that they will be allowed to fail if they make bad decisions; otherwise, the provision of capital has no real disciplinary effect. This is another aspect of the "moral hazard" problem mentioned throughout this article. Further, managers must be responsible to owners -- also achievable through adequate capitalisation and limitation of moral hazard.

Third, banks and other financial institutions need to have access to advanced risk reduction and hedging techniques, especially as currencies move closer to full convertibility. During the Mexican Crisis, the lack of access to risk sharing and hedging techniques contributed to the severity of the

³⁹ See, *inter alia*, P. Honohan, "Banking System Failures in Developing and Transition Countries: Diagnosis and Predictions", *BIS Working Paper* No. 39 (January 1997); M. Goldstein & P. Turner, "Banking Crises in Emerging Economies: Origins and Policy Options", *BIS Economic Paper* No. 46 (October 1996).

⁴⁰ For a thorough discussion of the role of secured transactions, see J. Norton & M. Andenas (eds.), *Emerging Financial Markets and Secured Transactions* (1998). In this context, it is understood that Thailand is in the process of revising its security/collateral laws. But, it must be remembered the taking of/and realising on collateral is only one side of the coin: a lender will have to have an available and liquid market to dispose of the collateral at good value, a situation currently lacking in Thailand.

impact of the crisis on the domestic financial system. During the East Asia crises, because of perceptions of currency stability, borrowers and lenders did not protect their foreign currency positions through hedging activities. In this regard, domestic derivatives markets should be developed, albeit very carefully, due to the complexities and potential dangers of these sorts of financial instruments. Recent standards by IOSCO are instructive in this respect.

2. Effective Corporate Governance.

In terms of improving the productivity of assets, a vital consideration is corporate governance. Without effective corporate governance, companies will not become more productive and efficient. Importantly, no single form of corporate governance model has emerged as dominant, but the important consideration is that corporations are in some way accountable to and monitored by their owners – whether public or private. Fundamentally, corporate governance is a reflection of policy choices, but it is also a reflection of underlying legal choices in the organisation of companies and financial relationships.⁴¹ Policy-makers must realise that the legal framework of business and finance relationships will determine the outcome of the economy's corporate governance system. Further, corporate governance concerns, especially in respect to the protection of minority shareholders' rights are of great importance to both international and domestic investors. While numerous countries have been looking at these issues around the world, no international consensus yet exists. The OECD, however, may attempt to synthesise some sort of statement of international principles of corporate governance. In line with increasing international concern in respect to corporate governance, this is an important issue that emerging economies should address. While conglomerates are beginning to disaggregate to some extent, the historical concentration of ownership and cross-linkages needs to be addressed, not only to encourage the involvement of international investors, but also to bring a larger portion of the population into the financial system and reduce efficiency-reducing structures while enhancing capital market liquidity.

3. Strengthening Domestic Capital Markets.

Domestic capital markets serve as an additional outlet for savings, as a mechanism for the generation of investment and as a vehicle (through a developed debt market) for the better matching of funds/liabilities. However, these markets take time to develop, especially as to the understanding of their

⁴¹ For development of this thesis in the context of the U.S., see M. Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* (1994).

dangers posed to investors, (as made especially clear from the political instability caused by the collapsing of pyramid schemes in Albania). Another, less threatening, situation can be seen in Shanghai where riots have occurred over share allocations.⁴² This situation is a danger in that there exists the possibility of the development of a classic "bubble market" in which share prices are pushed too high too quickly, and then when investor confidence is shaken by some event, crashes very quickly and with potentially damaging consequences, as happened in the UK in 1719⁴³ and the US in 1929.⁴⁴ In both cases, the crash led to severe economic consequences and a strong legal and popular reaction against capital markets.

This brings to light the need, then, for the second level of building blocks (following the creation of a general corporate infrastructure) necessary for the further expansion of domestic capital markets: a system of securities regulation that fosters market confidence through transparency and investor protection. As has been clearly shown by the development of the US securities markets and the increasing convergence of domestic securities regulatory regimes internationally, as demonstrated by harmonisation in Europe and proposals in Japan, transparency and a strong system of securities regulation fosters confidence in domestic capital markets, increasing investment and efficiency.⁴⁵

However, historical concentration of ownership and cross-linkages can severely impair the healthy development of a capital market. In order to increase international investment and its role as a potential engine for development, an emerging economy needs to address these problems because the capital market is not only a mechanism to attract portfolio investment, but also to attract foreign direct investment (FDI) and venture capital investors, to whom the stock exchange and its provision of liquidity provides a necessary and attractive means of eventual exit.

As one mechanism of developing domestic capital markets, further privatisation is an obvious (and generally effective) choice.⁴⁶ While there may be political obstacles in some countries in the region to such a process, this is an area where a country can take a leadership role, which could provide a demonstration effect throughout the rest of the region. At minimum, a country

⁴² See M. Wan, "The Securities System in China", in J. Norton & Y. Huang, (eds.), *Risk and Regulation in Chinese Financial Markets* (forthcoming 1998).

⁴³ See J. Carswell, *The South Sea Bubble* (1960).

⁴⁴ See J. Galbraith, *The Great Crash of 1929* (1954).

⁴⁵ For development of this hypothesis in the context of the U.S., see J. Seligman, *The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance* (1982). In the context of Europe, see B. Steil, *The European Equity Markets* (1996).

⁴⁶ Cf. J. Norton, "Reflections on Developing Capital Markets and Securities Regulation in the Countries of Central and Eastern Europe", in K. Hopt (ed.), *Developing Capital Markets in Middle and Eastern Europe* (forthcoming 1998).

needs to develop a more market-oriented, transparent and accountable system for overseeing and managing its state enterprises.

Finally, as already mentioned, the development of domestic derivatives markets for risk-sharing and hedging are important to financial stability and also allows investors (especially institutions) to protect their investments from adverse shocks to currency rates.

However, addressing the risks posed by the development of derivatives markets are complex and must be approached carefully. At the same time, as experiences in Russia have shown, if these sorts of products are necessary or viewed as desirable, they will develop independently of regulatory efforts. For that reason, it is best to take a considered approach to their development that moves in tandem (or just ahead of) market needs.

4. An Effective Insolvency Regime Combined With a Clear and Predefined Social Safety Net.

Not all banks and other firms will be capable of survival, nor should they. As one aspect of corporate governance, those that are not should be faced with a viable threat of bankruptcy.⁴⁷ Unfortunately, at the moment, many banks and other corporates in developing countries are simply “too big to fail” because of their vital role in social and political stability. This indicates the necessity for important government policy choices in these areas. In most cases, an effective insolvency regime must be combined with an effective social safety net in order to allow banks and other companies to become insolvent without severe domestic consequences.

The dangers inherent in this situation can be clearly seen from the recent riots in South Korea resulting from intended government changes to the system of lifetime employment there. Further, in order to decrease moral hazard, any safety net for depositors must be clearly and explicitly defined before the onset of any crisis situation. In addition, a minimal system may in fact attract small depositors into the system who might otherwise have remained outside.⁴⁸

B. Law Reform in the Search for Financial Stability and Sustainable Development

While legal standards and themes are of high significance, they are in fact the easy part of the process: the difficult process of implementation in countries around the world still lies ahead. This is the point where countries

⁴⁷ For an excellent and unique compilation concerning legal and economic issues of international and comparative insolvency, see J. Bhandari & L. Weiss, *Corporate Bankruptcy: Economic and Legal Perspectives* (1996).

⁴⁸ See, *inter alia*, H. Kaufman, *The U.S. Financial Systems* (1995).

must make their own decisions; however, this author thinks it is useful to note a few basic themes, and also to make certain suggestions in this regard.

1. *Insights Into the Domestic Economic and Financial Law Reform Process in Emerging Markets.*

Five words can be seen to embody the lessons of recent financial crises for the law reform process: “chance”, “coherence”, “sequencing”, “evaluation”, and “interconnection”.

a. Chance. While academic analysis perhaps can categorise the development of different countries in different tiers and groupings, analysis and experience indicates the law reform in each country is *sui generis* and should be treated as such. Elements of chance have certainly been present in numerous country situations; but, the broader lesson is that each country presents an individual setting for law reform. Quite simply, there is no universal model! Where an emerging economy has increasingly been involved in the development and its quick assimilation of international models, there exists now a need to re-focus certain elements of the domestic educational structure to take account of these developments and their underlying rationales. This need is even clearer in the whole of East Asia.

b. Coherence. According to many writers, a country may not need to adopt one total system, but often should “pick and choose”, as it appears to be best in defined situations. However, such an amalgam should be a “mosaic”, which implies co-ordination and coherence. Uncoordinated, piecemeal adaptations may, in the long-term, be counterproductive.

It is within the timeframe where exchange controls are to be eliminated and the system fully opened to the international financial system that crises seem most common and potentially damaging. While the nations of East Asia are at different stages of capital liberalisation, these issues are of much significance, given the recent experiences in East Asia. For these reasons, it is important that reforms and liberalisations are not done in a piecemeal fashion, but according to a broader picture of the eventual goal. It is in this respect that the need for careful analysis of any potential underlying problems remaining must be done and these problems attended to before they are exposed to the waves of the international financial system.

c. Sequencing. The “European Union model” is based on this concept. However, sequencing is not a mechanical process, but should be customised and “fine-tuned” on a country-by-country basis. The need is to approach law reform from a “made-to-order” and not from a “ready-made” perspective. As has been demonstrated, improper sequencing (*i.e.* liberalisation preceding strengthening) of financial reforms has been a critical underlying factor in

many financial crises. In light of the need for coherence, proper sequencing must also be carefully attended to. This must especially be the situation in the case of financial harmonisation and liberalisation.

d. Evaluation. Clearly, economic law reform efforts to date have been largely unscientific processes, with little or no built-in procedures to ensure accountability, monitoring and re-evaluation. The need for appropriate and on-going monitoring and evaluation mechanisms are perhaps the ultimate challenge for IFOs, IFIs and concerned emerging economies. As can be seen, temporary success is not sufficient evaluation. Domestic efforts must focus on determining potential problems before they are exposed by the market and treating them decisively and effectively. As noted before, small- and medium-sized, open economies do not have the luxuries that large economies do in this respect.

e. Interconnection. Today, various areas of law reform are inextricably interconnected (e.g., banking with securities law reform). The need for interconnection of related and interlinked areas of law reform cannot be understated, although it is sometimes neglected, even in the “developed” world. Once again, underlying problems such as those described in the context of corporate governance need to be addressed before they impact some seemingly unrelated (and potentially economically significant) variable or vulnerability.⁴⁹

With these thoughts in mind, different nations may need to adopt solutions corresponding to their different levels of development and their different needs, especially in relation to the financial sector; however, this must be done carefully, thoughtfully and rationally—not simply at the behest of foreign investors or the IMF or even out of desire to appease the World Trade Organisation (WTO).

2. Other Underlying Law-Related Issues.

In terms of domestic implementation (as well as international standard setting), a number of issues flow throughout any analysis of specific issues to be addressed in respect to devising appropriate legal infrastructures, namely:

- accounting and auditing standards,
- transparency,
- a strong Rule of Law and the reduction of corruption, and
- the creation of a favourable international investment environment.

⁴⁹ Some suggest that this may be a problem in South Africa: see J. Sikhakhane, “Open Season: Some Are More Equal than Others”, *Fin'l Mail*, 10 Apr. 1998.

a. Accounting and auditing standards. Accounting standards clarify relationships and encourage investment, both domestic and foreign, because they provide an understandable common language for businessmen to communicate about their businesses and finances.⁵⁰ In addition, internationally accepted accounting standards encourage investment because they provide transparency and comprehensibility. For these reasons, consistent accounting standards are absolutely essential for the success of continued financial stability and development in any emerging market economy. With the accounting profession applying internationally accepted accounting standards that should not be compromised, companies will gain greater experience and confidence with accounting systems and practices, thereby increasing their own role in the international financial system. Perhaps more importantly, business people in emerging markets will find that clear systems of accounting are not only good for encouraging foreign investment, but also for their own internal management purposes and maintenance of profitability in the long term.

Consistent accounting standards are absolutely essential for the success of enterprise reform in any country. Accounting standards clarify relationships and encourage investment, both domestic and foreign. Further, accounting standards are the basis of the operational fiction that in many cases allows financial institutions to continue to exist in the face of probable technical insolvency. While accounting standards must eventually be internationalised in order to provide transparency for both domestic and international investors, this process can be gradual as internal problems are eliminated, currencies move towards convertibility, and markets open to international capital.

In regard to international accounting standards, IOSCO and the IASC have committed to the development of international accounting standards for securities firms and companies by July 1998.⁵¹ This development will be of massive importance to all countries wishing to participate in international capital markets. The development of such standards will mark the creation of a truly international language of finance and investment, allowing comparisons to be made directly between investments in different markets. For that reason, all countries (including the US) would do well to consider the developments in this area and to work to use and facilitate the use of such international standards.

In particular a country's on-going involvement in the IASC and assimilation of its efforts should be encouraged. Also, the role of regulatory authorities in fostering and in shaping appropriate accounting rules and

⁵⁰ See, e.g., D. Mercado, "Evolving Accounting Standards in the International Markets", Practising Law Institute, *Corporate Law and Practice Course Handbook Series*, No. B4-7166 (Oct. 1996).

⁵¹ See IOSCO, *Annual Report 1996*. See also the website of the IASC at <http://www.iasc.org.uk>.

practices for domestic financial and business institutions should not be underestimated.

b. Transparency. Transparency is necessary so that all the various players understand the rules of the game, so that the game can continue successfully.⁵² As the recent experiences of Thailand, South Korea and Japan have shown legal and financial transparency is of the utmost importance in the long-term successful development of an effective financial system.⁵³ The emerging international consensus on the requirements for financial stability is built on the principle of transparency, and for this reason, the financial and legal infrastructure of any emerging market must be transparent. Moreover, the advantages of transparency are as a baseline for financial and legal development and resulting financial stability and economic success.

Transparency is necessary not only for international investors, but for domestic investors as well. Transparency is necessary in whatever solution a government chooses to resolve banking problems, because without it, investors, companies, banks and markets will not understand and will not have confidence in the process chosen. It is necessary in accounting so that investors can determine values for productive and non-productive assets and make decisions accordingly. It is necessary for banks in order to lengthen loan horizons and evaluate borrowing and lending decisions. It also is necessary for capital markets in order for investors to understand the nature and risks of investing in securities and thereby prevent the potentially disastrous rise and collapse of stock market bubbles. Finally, it further is necessary for international investors to make comparisons and to make secure and well-thought-out business decisions, which will benefit not only themselves, but also companies making choices that encourage investment and eventual success in the market.

Both the Mexican and the East Asian crises were triggered and exacerbated partly when investors found out that reserves were smaller than they had thought and that short-term debt was higher.⁵⁴ One of the many lessons drawn from Mexico and East Asia is that the extent of the crisis was worsened by the poor quality of information supplied to both the official sector (including the IMF) and the markets (and perhaps even by well-meaning government suppression or distortions of critical information in the hope of buying more time for the reform processes to set in). The East Asian crises reinforce the

⁵² See, e.g., L. Lowenstein, "Essay: Financial Transparency and Corporate Governance: You Manage What You Measure", 96 *Colum. L. Rev.* 1335 (June 1996) (discussing the importance of transparency in the US financial system).

⁵³ See, e.g., S. Sugawara, "Market Troubles Felt Far and Wide", *Int'l Her. Trib.* (8 Nov. 1997) at 1.

⁵⁴ Stiglitz, "Boats, Planes and Capital Flows", *op. cit.*, n. 2.

argument for better and more timely provision of information, including information on central bank forward operations.

There are two arguments in this regard: (i) better informed markets are likely to make better decisions, and in both Mexico and in Asia, this would have meant that markets withdrew funds sooner than they did, thereby hastening adjustment; and (ii) the obligation to publish information on certain interventions would affect the extent and nature of those interventions, helping to prevent some unwise decisions. In this regard, at the moment, the IMF is only seeking to further strengthen its Special Data Dissemination Standard (SDDS); however, it is quite possible that stronger measures will soon be forthcoming.

According to Greenspan, the primary protection from adverse financial disturbances is effective counterparty surveillance and hence, government regulation and supervision should seek to produce an environment in which counterparties can most effectively oversee the credit risks of potential transactions.⁵⁵ In this respect, a "major improvement" in transparency, including both accounting and public disclosure, is essential. However, given the financial crises earlier in the decade in Norway, Sweden and Finland—countries with highly transparent economic systems and advanced institutional frameworks—, more transparency is probably not sufficient in and of itself.⁵⁶

Thailand needs to be an active participant in the SDDS. While this may seem to expose a potential vulnerability, as was shown with similar though undisclosed net open forward positions in Thailand, international advance knowledge of weakness is preferable to investors discovering that a perceived stable situation was in fact completely untenable, resulting in rapid deterioration of confidence and capital flight.

Yet, in this author's view, the long-term benefits of enhanced disclosure and surveillance need to come, principally, on a regional or sub-regional and on a "per country" basis (with closer communications changes with reputable private, local market analysts), and not from undue reliance on the surveillance mechanism of the international monetary and financial institutes.

c. A strong Rule of Law and the reduction of corruption. The emerging international consensus is that a transparent, predictable and enforceable legal regime underlies successful economic development.⁵⁷ It is important for investors and businesses to feel that their investments are safe and can be protected in order to provide the necessary confidence in the financial system.

⁵⁵ Greenspan Testimony 30 Jan., *op. cit.*, n 1.

⁵⁶ See Stiglitz, "Bad Private-Sector Decisions", *op. cit.*, n 10. It may be argued, however, that in the context of these countries, problems were exacerbated by the existence of implicit government guarantees and explicit currency pegs similar to those that finally in fact led to the crises in Asia and Mexico.

⁵⁷ See G-10 Report, *op. cit.*, n 25.

The "Rule of Law" as to economic or other societal regulation is of little practical value unless fair and effective enforcement can be attained and sustained. As such, regulatory authorities require adequate personnel and technological capabilities to ensure effective enforcement. The enforcement must also be fair, both substantively and procedurally: this will require transparent and judicially reviewable administrative processes. Also, administrative enforcement cannot entirely be fair and effective without an independent, well-educated and non-corrupt judiciary.

Corruption can undermine the reform process by reducing public confidence.⁵⁸ As corruption increases, confidence in the fairness and openness of the financial system decreases, causing investment to decrease and move to other shores. In this regard, the recent experiences of Hong Kong are instructive: its system must be allowed to continue its anti-corruption efforts in order to maintain its status. However, Singapore has become increasingly competitive: while its legal system is viewed as very strict, it is also viewed as largely non-corrupt. Thus, for example, if Hong Kong SAR is increasingly viewed as a less fair and open place for business, then business will increasingly move to Singapore, with its strict, but fair and non-corrupt system.⁵⁹

While corruption in some countries such as China, Russia and certain countries of Latin America is of international concern, it nonetheless must always be a concern in any country. From the standpoint of general financial stability, if corruption is too pervasive, confidence in the financial system will weaken and investment and stability will decrease. From the standpoint of banking, if corruption palpably exists, banks may be weakened by insider lending practices, such as has been the case in Thailand, Indonesia and Korea—these are the moral hazard problems discussed earlier and commonly referred to as "crony capitalism". Finally, from the standpoint of capital markets, corruption can cause wariness to invest due to perceptions of a "rigged" market or can in fact shake confidence to such an extent that the market collapses. Corruption in fact can be seen as the primary cause of the collapse of the UK stock market at the time of the South Sea Bubble in the early 1700s.⁶⁰

Corruption, however, does not necessarily equate with the absolute requirement of arm's length business transactions. In some cultures, such a solution is obviously impossible; however, a few requirements are probably in

⁵⁸ For detailed information on the impact of corruption and international efforts to combat it, see the homepage of Transparency International, an organisation formed to monitor and encourage international efforts against corruption, at <http://www.transparency.de/>.

⁵⁹ See C. Kin-man, "Combating Corruption and the ICAC" in J. Cheng (ed.), *The Other Hong Kong Report 1997* (1997) 101.

⁶⁰ See Carswell, *op. cit.*, n 45.

order: maximum lending limits to a single borrower in line with international standards, prohibition and punishment of market manipulation, and the punishment of self-dealing, perhaps through the development of corporate fiduciary duties. Obviously, such minimums protect ownership interests, as well as enhance general confidence in the financial system, and so should be strongly implemented.

Given the East Asian historical situation and the strong domestic perceptions of corruption and crony-capitalism, efforts in this respect are of great significance⁶¹. Most importantly, these problems undermine domestic confidence in capital markets, the financial system, the judicial system, and individual perceptions of potential for development and success. Efforts to update laws on monopolies and insider lending and dealing, along with appropriate enforcement of these sorts of provisions, would help to reduce perceptions of a rigged financial and judicial system and increase domestic, as well as international, participation.

In this latter context, recent efforts of certain East Asian regulatory authorities to emphasise enforcement needs to be applauded. Certainly these financial regulators need to be in a period of consolidation, revaluation, monitoring and enforcement. But, enforcement practices need to be fair, open, rule-based, reviewable and balanced: over aggressive enforcement should not be used as a substitute for/or conflictive respecting poor under government practices and could lead to an unwarranted "chill" on legitimate business and financial activities (e.g., as occurred in the United States during the 1989-92 period).

d. Favourable environment for international investment. International investment encourages growth and the transfer of know-how; however, as shown by experiences in other countries (e.g., Mexico in 1994-95 and Thailand, Indonesia and South Korea in 1997-98), investment can also have its dangers.⁶² In terms of the creation of an environment favourable to international investors, developing countries probably have two primary focuses: first, attracting foreign investment; and second, access of domestic companies to international capital markets.

In order to advance the process of foreign investment, the factors already discussed are of prime importance, i.e. international banking standards, effective corporate governance, improving domestic capital markets, an effective insolvency regime, international accounting standards, transparency, and enhancing the rule of law and reducing corruption. The combination of effective implementation of the above should ensure the confidence of foreign investors.

⁶¹ See *Traisorat*, *supra* n.9

⁶² See, e.g., *Amer*, *op. cit.*, n 12.

Second, in regard to access to international capital markets, the same set of factors is once again implicated; however, a few comments are worth highlighting. Even more so with international markets than with domestic investors, international investors must understand the nature of the government's policy solution before they will be willing to take part in it. Only with such transparency and certainty will such investors have the necessary confidence to take part in the process. Further, as a vital aspect of the process, any access to international capital will require transparent and effective accounting standards. Without this basic device, domestic companies will not be able to list their shares on other markets and international investors will likewise not be able to evaluate and invest unless they understand the relevant accounting standards.

IV. CONCLUDING OBSERVATIONS

Unfortunately, despite our best efforts, we do not seem to be able to present any comprehensive solution to the problems of financial law reform in emerging markets. While the emerging international consensus is very important and useful in terms of general standard setting and detailing of policy options, no one choice is always appropriate, but rather must be tailored individually in each case. In this regard, it is obviously important to Thailand to look to learn any lessons that it can from the experiences of Mexico and its other East Asian neighbours in order not only to avoid these sorts of crises occurring again, but also to enhance its own national path of sustainable development.

A. Lingering Problems

Looking specifically at the overall problems likely to continue to effect the financial systems in many emerging markets for the near future, the following come to mind: the weakness of banking institutions, the prevalence of corruption and crony-capitalism, the lack of effective and consistent regulatory enforcement, the lack of sophisticated and efficient judicial mechanisms for the resolution of financial disputes, the inexperience of market participants, and the shortage of domestic savings.

At a more fundamental level, the inefficiencies of general corporate law and of investment firm regulation, and in particular the absence of appropriate solutions to questions of conflicts of interests and insider-dominance in corporate governance and securities activities, are likely to impede the smooth and rapid maturation of financial systems. While the financial systems of the affected East Asian economies are maturing, these sorts of problems are likely

to be of major importance in the near future, given these countries' need to develop confidence and broaden participation in its financial system and the range of financial instruments (including suitable debt and derivative products).

These are all problems without easy, quick or necessarily direct solutions. However, I think that in the final analysis that we can agree on a few points. First, the international standard setting process is encouraging in that in the past little attention was paid directly to this very important issue and little was done directly to address these fundamental problems. Second, the role of the intergovernmental organisations (whether on a world-wide, regional or sub-regional level) and of internationally-oriented domestic institutions in weaving together the strands for sustainable financial and economic development in transitioning and emerging economies cannot be underestimated, yet they cannot be overestimated. This role can be viewed as largely directive (in a general sense) and supportive of a particular country's national commitment to true market, legal, political and social reform.

B. Short-term Capital Flows

Some are now arguing that short-term capital flows such as those that triggered the recent financial crises in Mexico and East Asia do not bring ancillary benefits, but instead only increase the vulnerability of an economy, especially in situations such as East Asia where high domestic savings rates existed and resulted in misallocation of marginal investment.⁶³ Even the editors of the *Financial Times* (London) agree that the case for early and complete freedom for international capital flows has been damaged and that the question is how to maximise the benefits of capital flows to developing countries, while minimising both the number of panics and the damage they cause.⁶⁴ The question, and it is a complex one that no one knows the answer to, is how to do this. Joseph Stiglitz, Senior Vice President and Chief Economist of the World Bank, suggests that at the domestic level, first, tax, regulatory and policy distortions that may have stimulated such flows and encouraged short-term foreign borrowing, such as the Bangkok International Banking Facilities, need to be eliminated. Second, capital in-flow inhibitions, such as those in Chile (essentially a tax on short-maturity loans), may be appropriate. The suggestion being that these, together with solid fundamentals and a sound financial system, may be the reason that Chile has been relatively unaffected by recent crises. In the future, however, because the East Asian and other emerging economies will continue to need international capital for development, it would do well to focus on mechanism such as lending infrastructure and domestic currency markets to encourage

⁶³ Stiglitz, "Boats, Planes and Capital Flows", *op. cit.*, n. 2.

⁶⁴ "Asia: Regulating Capital Flows", *Fin'l Times*, 25 Mar. 1998.

longer-term, domestic currency lending, while at the same time increasing and protecting its international reserves.

C. Regional Responses to Financial Crises

Also, in terms of East Asia we are not speaking of only domestic reform, but about developing realistic, viable and workable mechanism for pursuing this reform process on an appropriate regional or subregional basis.

The globalisation of financial markets has increased the complexity of the international financial system and the volume and size of international capital flows. These complexities present new challenges and opportunities to international trade arrangements, law reform, and economic development. In the 1996 Lyon Summit *Economic Communiqué* the G-7 nations asserted that, in calling for the strengthening of economic and monetary co-operation, their respective economic policies would continue to be co-ordinated towards sustaining non-inflationary growth and that its finance ministers would continue to co-operate closely on economic policy and in the foreign exchange markets.⁶⁵ The G-7 declared that strong and mutually beneficial growth in trade and investment "will be sustainable and therefore most beneficial to all if conducted within a strong multilateral framework of rules", thus reaffirming the central role of the World Trade Organisation (WTO) and the pre-eminence of multilateral rules to serve as the framework for regional initiatives.⁶⁶

The recent crises have highlighted the potential role of regional organisations. Because of the different levels of development and openness to the international financial system in the region, it is extremely important to take into account in the drafting process the tension between liberalisation, safety and soundness and the potential for financial crises discussed earlier.

According to Stiglitz⁶⁷, in addition to global standards and risk protection, a complementary regional response is also warranted, primarily because contagion effects have tended to be strongest within the region of the country immediately effected. Further, regional/subregional neighbours may be better poised both for cost effective surveillance and for effective peer monitoring. Possible mechanisms include funding, surveillance and technical co-operation.

Beyond the high profile efforts of the European Union, other regional organisations are beginning to venture into the financial sphere. Of most recent note, of course, are the recent initiatives being taken in Southeast Asia, through the Association of South East Asian Nations (ASEAN). Beyond

⁶⁵ See, e.g., TEXT, "Economic Communiqué From G-7 Summit, Lyon, France" (issued 28 June 1996), reprinted in *BNA Int'l Trade Rep.*, vol. 13, no. 27, at 1104 (July 3, 1996).

⁶⁶ *Ibid.*

⁶⁷ J. Stiglitz, "Statement to the Meeting of Finance Ministers of ASEAN plus 6 with the IMF and the World Bank", *op. cit.*, n 62.

Southeast Asia, NAFTA and Mercosur are both increasingly influential in the sphere of financial regulation and supervision within their respective member countries, and should become even more so if the preliminary international work currently underway following the April 1998 Second Summit of the Americas held in Santiago, Chile is any indication of the future.

In looking at regional integration a “bottom-up”, “building block” strategy is perhaps best. Under this approach, the first stage is focused on laying an appropriate foundation in the form of an effective institutional framework for the financial system in each country, including an independent central bank and the establishment of private institutions and markets. Following this initial programme (by no means an insignificant accomplishment), the goal is then to look at issues of market access and potential harmonisation and integration. If a similar coherent and sequenced approach had been followed in respect East Asia’s entry into the international financial system, the crises there might have been avoided.

It should be noted, however, that the East Asian countries face a number of challenges that must be addressed in their efforts to address these sorts of integration issues. The nations of the region span a wide range of economic, political and social development. For that reason, a political choice to focus first on co-operation, then co-ordination, followed by possible eventual harmonisation may be a wise and pragmatic one indeed. Not only does such a “road map” reflect the *realpolitick* of differences in development and sensitivities to sovereign “pressure points”, it also reflects the real underlying needs of the constituent nations: development, not political integration. These efforts can be further complicated by the existence of IMF and other self-imposed structural adjustment programmes in numerous nations throughout the region. These pre-existing requirements must be taken into account and internalised within any integration process.

In all of these things, however, the role of law and the threat of law-based failures creating potentially self-fulfilling vulnerabilities cannot be ignored. As such, legal efforts must first be aimed at preventive and developmental measures in the immediate time frame, with harmonisation and integration as secondary goals over a longer horizon.

D. Success Factors in Development

This author would like to leave with a few optimistic thoughts. It is important while looking at the negatives of recent crises, not to forget the positive lessons that have underpinned the successful growth of the East Asian countries over the past decades.⁶⁸ Some of the most important features of East Asia’s development were sound macroeconomic fundamentals, including high

⁶⁸ See World Bank, *The East Asian Miracle: Economic Growth and Public Policy* (1993).

savings; a commitment to education, technologically advanced factories; a relatively egalitarian distribution of income; and an aggressive pursuit of foreign exports. These elements are still present, not only suggesting that East Asia's future will be bright, but further that these elements can continue to provide a model for successful development throughout the world.⁶⁹

These elements are instructive for emerging economies. First, in order to increase macroeconomic stability, unemployment needs to be addressed. In this respect, longer-term commitments should be made to improving education and training throughout the population. Only in this way will the groundwork be laid for successful development and rising incomes.

Another idea that might bear consideration would be the development of a securitised mortgage market (enhanced with appropriate tax incentives), resembling that in the US.⁷⁰ Instructive success is currently being achieved on a similar scheme in Hong Kong,⁷¹ and, in this context, it is important to note the recent Thai passage of a securitisation law and incipient practical efforts in this area. Such a development provides a mechanism to strengthen domestic capital markets, increase investment in housing, encourage savings and investment and economic participation through home ownership. Moreover, it should provide a mechanism to draw in long-term foreign investment into the domestic capital markets, providing the potential for growth in the housing market and related employment in the construction industry. While this is but a small thought, ultimate success will not be created from any single idea, but rather through the development of an inclusive culture that encourages economic participation and is underpinned by respect for the rule of law.

E. Educational Infrastructure Needs and Meaning for the "New Banking Law"

The fundamental reform problems are long-term and will depend upon the building of an appropriate legal and educational infrastructure within a particular country, along with the development of a cultural ethos conducive to the development of transparent, open and non-corrupt financial markets and financial institutions and a judicial and administrative framework staffed and supported by a well-trained and honest bureaucracy and legal and accounting profession. We are not talking solely about economic reform or transition, but more broadly about legal, social, political, educational and cultural reform.

⁶⁹ Stiglitz, "Bad Private-Sector Decisions", *op. cit.*, n 33.

⁷⁰ For a discussion of the securitisation and the elements necessary to underpin a successful system, D. Barbour, J. Norton & T. Slover, "Securitisation in Emerging Markets", in 2 *Yrbk. Int'l Fin'l L.* (forthcoming 1998).

⁷¹ For details, see the website of the Hong Kong Monetary Authority, Hong Kong SAR's *de facto* central bank, at <http://www.info.gov.hk/hkma>.

Also moves toward increased co-operation on the international, regional and national levels can shine considerable light on the **formulation, implementation and (as yet to be directed to any significant degree) monitoring and evaluation stages** of meaningful economic and law reform in emerging economies, particularly as these reform efforts are geared to the development of viable and sustainable financial markets. However, it is in this respect that international co-operative efforts within the educational system can be of immense importance to the long-term development of the country, to its financial and monetary regulators and to the private financial and business sectors. Academic linkages to the rest of the world need to be strengthened in order to provide the basis for the development of a country's human capital necessary for true social, political and economic development.

What might all this mean for the future teaching of banking law in Thailand? In terms of the future expanding regulatory content of "banking law" for legal education, general and specific efforts towards international supervisory and regulatory convergence respecting international banks and securities firms (and other international financial institutions) should undoubtedly be of continuing importance to legal educators as we approach and enter the Twenty-First Century. Improved convergence in the regulation and supervision of financial conglomerates, derivatives, disclosure of trading activities, and effective money laundering measures are all on the current agenda of the international bank and securities authorities.

This taken into consideration, one quickly realises that the nature of the banking business (and of banking institutions and of financial markets) is in a dramatic state of metamorphosis. This metamorphosis is not only one of market interconnections but of national-regional-international interdependence. On the educational institution side, a close interdisciplinary and international co-ordination among leading East Asian and international Universities would appear to be highly desirable. In all events, the study of the "New Banking Law" in the Twenty-First Century in East Asia (and elsewhere) will be influenced radically by this on-going metamorphosis.

As to commercial law, it speaks for itself that many of the activities of banking institutions (such as the taking of deposits and dealing in cheques and other negotiable instruments, credit instruments, the taking of security), a viable insolvency regime, and effective dispute resolution mechanisms will remain "core" aspects of any future banking law. Further, the bank-customer relationship (whether as depositor or lender) will continue to be essentially contractual and commercial in nature. Yet, the increasing role of electronic technology in banking and financial services will raise new legal issues that will need to be addressed by an evolving commercial law. In any event, commercial-law must remain an important integral, core component of the "New Banking Law".

Also, to the private law dimensions of the "New Banking Law", this will be heavily influenced by technological and product innovations in the increasing cross-border dimensions of banking/financial transactions.

Comparative understanding of the legal experiences of others (e.g., US, Japan, EU, Latin America) will be highly desirable, as will be an understanding of the international legal implications of the international convergence and co-operative processes underlying the financial markets/institutions area. Further, a better understanding of private international law (conflict of laws) will be critical as financial transactions are increasingly becoming cross-border in nature.

In logically thinking through an optimum educational matrix for the study of banking law in East Asia in the 21st Century, the importance of interconnecting the following also becomes clear: accounting principle, taxation rules, corporate law, property security and bankruptcy laws, and the development of legal approaches to new financial market innovations (e.g. swaps/derivatives and asset securitisation).

Overall, the future for legal education in East Asia should not be clouded by legal, cultural or ideological nostalgia, but should embrace academic innovation, openness and even daring in creating an educational process of transmission and assimilation. Such an approach is sure to lead to a greater intelligibility and receptivity (domestically, subregionally, regionally and internationally) of the ongoing changes and innovations in the financial services areas. All of this should contribute to even higher academic standards in legal teaching and scholarships. Legal teaching and scholarship should become more enriched and made more relevant by the experience.

But creating the appropriate, long-term educational infrastructure is not simply about interdisciplinary university education, but is more generally about building a "partnership" of educational and training efforts among the universities, the relevant financial sector bureaucracies, the judiciary and responsible elements of the domestic private financial and business sectors.

In conclusion, this author stresses that the ultimate goal should be to develop and to sustain viable and economically contributing financial markets within an appropriate private and public legal framework and "educational partnership." With the continued and sustained commitment of all sectors of a country's political, economic and civil societies, and with a betterment (or at least a stabilisation) in external factors (e.g., as to the Japanese and P.R.C. situations) there indeed should be a "silver lining" in the East Asian crises clouds and there should be a rainbow at the end of the storm.⁷²

⁷² The author points favourably to the new Thai constitution and insolvency law, the closure of 57 finance companies, stricter enforcement procedures in the financial sector, and a more rigid approach to accounting rules.

The author of this piece, Professor Joseph J. Norton AB, LLB, LLM, SJD, Dipl (Hague), DPhil (Oxon), is the Sir John Lubbock Professor of Banking Law, Centre for Commercial Law Studies, University of London and the James L. Walsh Distinguished Faculty Fellow and Professor of Financial Institution Law, S.M.U. School of Law, Dallas, Texas. He is also the Founder and Executive Director of the London Institute of International Banking, Finance and Development Law, which conducts significant law reform programmes, publication efforts and training sessions on a world-wide basis. In addition, he is Of Counsel, at Andrews & Kurth, L.L.P., Texas and London. Professor Norton served as Editor-in-Chief of *The International Lawyer* for ten years, and now serves as Editor-in-Chief of *NAFTA: Law and Business Review of the Americas*. He has authored (for US, UK, Japanese and Chinese publications) over eighty articles or chapters on business and banking law matters; and he is the author, co-author, or editor of over 30 books. The professor is also the Chief Law Examiner for the University of Hong Kong; an elected member of the American Law Institute; a Vice President of the Southern African Bank Lawyers' Association; a Senior Visiting Professor at the Institute of International Business Law (Muenster, Germany); and the Director of the SMU Institute of International Finance (Financial Law Group) and the SMU NAFTA Law Centre.

**Efficacy of Developing International
Standards and the New Architecture: Of the
IOSCO Process and Beyond**

Mr. Andrew Procter

Introduction

At its 1999 Annual Conference, the International Organization of Securities Commissions (IOSCO)¹ adopted the *Objectives and Principles of Securities Regulation*², setting forth 30 “core” *principles* of securities regulation. Only one of the more than 100 member jurisdictions voted against the document and that was New Zealand. The *Principles* are based on three fundamental objectives of securities regulation:

- the protection of investors;
- ensuring that markets are fair, efficient and transparent; and
- the reduction of systemic risk³.

The 30 core *Principles* give practical effect to these three objectives. Together, the *Objectives and Principles* and are intended to give guidance to regulators and serve as a yardstick against which to measure progress toward effective regulation.

I chaired the Committee that was responsible for drafting the *Objectives and Principles*, so I am well aware of some, though perhaps not all, of its shortcomings. The document reflects the agreement of the Organisation on what securities market regulation should be like but it also reflects the

¹ For information about IOSCO, see Attachment 1. Source IOSCO’s internet homepage.

² The full text is available from the IOSCO internet site at <http://www.iosco.org/iosco.html>

³ A list of the 30 *Principles* is at Attachment 2. The full document runs to more than 50 pages and includes commentary on each *Principle*.

diversity of legal traditions and the various acceptable approaches to regulation to be seen in member jurisdictions. Certainly, it was the product of some compromise, though less so than most expected it to be at the outset. Certainly, the *Objectives and Principles* are expressed at a high level of generality though the document contains more detail and guidance than comparable documents in the banking and insurance sectors such as the Basle Committee on Banking Supervision's, *Core Principles for Effective Banking Supervision*. Certainly, it is not a blueprint for the design of securities of securities regulation, though any jurisdiction that could honestly say that it had implemented all of the *Principles* would have a very solid foundation for its regulation.

When compared with the banking or insurance sectors, I think it is a more difficult task to agree upon common principles for the securities sector because of the very different stages of market development, the much greater variety of structures and traditions in the securities markets, and the wider range of issues for which securities regulators are responsible. Those difficulties are reflected in the express acknowledgement in the IOSCO document that there may be several regulatory strategies available to achieve a particular *Principle*. That in turn makes it more difficult to evaluate whether a jurisdiction has successfully implemented the *Principles*.

The question that fairly arises is whether the exercise was worthwhile. In part it was a response to growing political expectations being voiced by, amongst others, the G7 Finance Ministers – but, if all that was achieved was

a quieting of those political demands then it will have been a lot of work for little reward.

The early signs are encouraging.

Several jurisdictions are already critically evaluating their regulation against the IOSCO standards. The international financial institutions are beginning to make use of the IOSCO document. There is even some talk of regulatory capital requirements for financial institutions being linked to a jurisdiction's compliance with the *Principles*.

I should, however, note that IOSCO is not an institution that imposes standards. Although a Member will be expected to implement the IOSCO *Principles*, there is no penalty for failure other than the exposure of that failure. That is, of course, a matter of critical importance to which I shall return later.

Promoting Compliance

What then is IOSCO doing to promote compliance with the *Principles*?

In February 1999, a Task Force was established to implement a two part mandate on implementation. The first part of the mandate is concerned with implementation itself and the second part on developing strategies for working with the international financial institutions ("IFIs") in capital market development – particularly in ensuring high standards of regulation.

The Task Force is chaired by the Securities and Futures Commission, Hong Kong. There are 21 IOSCO members, drawn from all regions. All of the G7 countries are represented. Those members are, however, merely the workers and the intention is to secure Organisation wide support for the strategies adopted.

Consistent with the second part of the mandate, on cooperation with IFIs, invitations to attend Task Force meetings as observers have been accepted by: The World Bank, The International Monetary Fund, The OECD, The African Development Bank, The Asian Development Bank, The European Bank for Re-Construction and Development and The Inter-American Development Bank.

Work Program

Part 1: Development of Implementation and Assessment Methodologies for the Principles

There is, of course, no super regulator or other global agency responsible for ensuring that a jurisdiction meets IOSCO's *Principles*. As noted earlier, IOSCO does not assume a role as standard setter and there are no penalties imposed by IOSCO for failure to meet the standards set by the *Principles*. It is against that background that implementation strategies must be shaped.

The Task Force is essentially working on a three part strategy.

First, it is proposed that the Organisation should begin a two-part process of assessment.

Seized with the need to act promptly, and cognisant of the time required for a thorough self-evaluation exercise among more than 100 members of IOSCO, the Task Force proposes to structure the first part of the mandate as two exercises, to be run concurrently. The first part of this exercise, intended to provide a rapid assessment of current implementation among IOSCO members, will be a high level self-evaluation based on the entire *Principles* document. At the same time, more detailed self-evaluations will be performed on discrete sections of the *Principles*.

Completion of the high level survey with respect to all *Principles* will be an immediate and clear Organization-wide statement of commitment to those *Principles* and will focus the attention of individual regulators upon any areas in need of urgent reform. The more detailed surveys are intended to be very much more rigorous inquiries. Over time, it is intended that all aspects of the *Principles* will be subject to this more detailed assessment.

These detailed surveys are very detailed. They ask questions about regulatory structures, the content of laws, the development, content and implementation of policy, the resources devoted to a particular aspect of regulation, perceived shortcomings and proposals for reform. Moreover, they inquire into those matters by asking for the provision of objective

information from which inferences may be drawn, rather than calling for subjective expressions of opinion from the respondent.

Principles relating to “The Regulator” and *Principles* for “Issuers” are the first two discrete topics that have been selected for more detailed evaluation. These two areas are of great relevance to the stability of the international financial system.

Principles relating to “The Regulator” include principles for self-regulation and principles for enforcement of securities regulation (*Principles* 1 – 10), and cover subjects relating to the responsibility, independence, accountability, processes and powers of regulators. This work will complement the IMF’s work on the *Draft Code of Good Practices on Transparency in Monetary and Financial Policies*.

The *Principles* for “Issuers” (*Principles* 14 – 16) address matters of market transparency, accounting and auditing standards, and the fair and equitable treatment of shareholders. In addition to the importance of these subjects to the strength of the international financial architecture, this work will complement the work done by the OECD on the Draft Principles of Corporate Governance.

Working Groups have begun to prepare the questionnaires for these three self-evaluations. Current indications are that the Task Force will have completed the drafting of the three surveys by the middle of this year and

that the surveys should be ready for distribution to Members shortly thereafter.

The three surveys will allow both for an assessment of current levels of adherence to the *Objectives and Principles* and also to seek information on movement towards adherence. The *Principles* themselves are expressly said to be aspirational. If a jurisdiction does not presently meet the *Principles*, then they are expected to take steps to move towards compliance .

Use of the Surveys

The Task Force has yet to agree recommendations about the publication and availability of the survey results. Clearly, this is a matter of great importance. On the one hand, publication of an accurate and meaningful survey may bring pressure for change where change is needed. Publication of the detailed surveys would also, we think, be valuable for the IFIs in focussing their assistance, to emerging markets in particular. On the other hand, knowing that answers to a survey may be widely published may mean that the answers given are less than full and frank. That risk is particularly real where, as is likely in this case, completion of survey responses is largely a matter of self assessment.

It is clearly understood that self-assessment is not enough. Self-assessment can include a heavy dose of self-delusion and self-protection.

The Task Force has given preliminary consideration to the role to be played by IOSCO and its members in the evaluation process. Our present view is that the high level survey should be entirely a matter of self-assessment. We do, however, believe that there should be some checking of the answers to the more detailed surveys but that this should be limited to high level checking for completeness and comparability. Essentially, we have come to that conclusion for pragmatic reasons, to do with resources.

IOSCO has previously conducted a self-evaluation exercise pursuant to the 1994 IOSCO Resolution on “Commitment to Basic IOSCO *Principles* of High Regulatory Standards and Mutual Cooperation and Assistance”. The experience earned through that exercise will provide significant guidance to the Task Force in the design and execution of the self-evaluation based on the *Principles* and in the type of high level checking that I described.

The Task Force is considering the possibility of a full peer review process. Those familiar with the Financial Action Task Force (FATF) peer review process on measures to prevent money laundering, generally agree that such a peer review could be highly valuable but that it is very demanding upon resources. The FATF process is well-organised and well-resourced but only three reviews are conducted each year even though the FATF reviews are with respect to a comparatively confined subject. At that rate, it would take about 35 years to conduct peer review of IOSCO’s members!

Some individual members of IOSCO are considering a full peer review based on the *Principles*, inviting peers from two or three other jurisdictions to carry out the review and to report. There may be pressure for IOSCO to introduce institutional reforms to support such peer reviews.

The Role of the IFIs

I have earlier described the observers status of IFIs on the IOSCO Implementation Task Force.

The dialogue with the IFIs has only just begun but it is clear that there is considerable scope for cooperation. The IOSCO *Objectives and Principles* are being used by the IFIs in their work and they are looking to IOSCO for guidance and assistance in the areas covered by the document.

Early discussions with IFIs make clear a number of general propositions:

- the IFIs are increasingly interested in working to improve the quality of financial regulation and are very interested in working with IOSCO to that end;
- the IFIs are already using the *Objectives and Principles* in their work – using them as a basis for reform programs;

- the IFIs are in many cases inexperienced in the area of securities market regulation and reform (and certainly less experienced in securities markets than they are in the banking sector);
- there is a desire on the part of several IFIs to enlist the support of IOSCO and its member organisations to participate in fieldwork – actually reviewing a jurisdiction and making recommendations.

I have noted the likely sensitivity to publication of IOSCO's proposed surveys on compliance with the IOSCO *Principles*. That sensitivity may extend to making the information available to the IFIs. In my view, there are good reasons why the information should be made available as a valuable source of information that should help to focus the attention of IFIs and governments on the most pressing work needed in a particular jurisdiction. That debate, however, still lies ahead and we shall have to see how far IOSCO is prepared to go in practising the kind of transparency that its Members increasingly demand of the markets that they regulate.

What Else is IOSCO Doing?

Annexed to the IOSCO *Principles* is a list of other IOSCO reports, many of which are footnoted in the relevant section of the text. There are now more than 60 such reports and they include some valuable detailed work on specific aspects of securities regulation. Increasingly, there are also joint reports prepared with the Basle Committee on Banking Supervision and the BIS Committee on Payment and Settlement Systems covering matters such

as stock borrowing and lending and the recently published consultation paper “Recommendations for Public Disclosure of Trading and Derivatives Activities of Banks and Securities Firms”. The *Objectives and Principles* cannot be read in isolation from these more detailed reports and preparation of such reports continues to be a focus of IOSCO’s work.

Amongst other current IOSCO projects is the work of a Task Force on highly leveraged institutions but there is also a lot of less fashionable work being done in areas such as the regulation of collective investments, the recognition of value at risk models, and consideration of international accounting standards, particularly for use in cross-border listings.

All of this work makes a contribution to regulatory standards. When we in Hong Kong consider the need for regulatory reform, we do look to the IOSCO material as well as to regulatory models elsewhere to determine what is best for Hong Kong.

If one takes as an example IOSCO’s work on information sharing between jurisdictions, one can trace a progression from IOSCO reports and resolutions, to Memoranda of Understanding on information sharing (including necessary supportive law reform in many jurisdictions, such as Hong Kong), to the G7 taking up the issue and most recently the reform pressure being brought to bear on even the least cooperative jurisdictions. It took time but it illustrates that organisations like IOSCO can make a difference even in the absence of enforcement mechanisms.

IOSCO is also increasingly involved in the provision of training. IOSCO works with the World Bank and regional development banks including the Asian Development Bank in designing and providing specialist training for securities regulators.

Finally, IOSCO as an Organisation is a member of the newly established Financial Stability Forum and expects to contribute to its newly formed working groups⁴.

Reform IOSCO?

It might fairly be asked whether reform should begin with reform of IOSCO itself. Is a consensus driven organisation sufficient to help shape new financial architecture? Clearly not. IOSCO does not have an obvious lever to allow it to insist upon Member adherence to the standards that it sets. The lack of an IOSCO “stick” is a frustration to some of its reform minded members.

The securities markets, despite increasing cross border trading, despite growing links between exchanges and payment and clearing systems and despite the many intermediaries that operate in several jurisdictions, are almost entirely domestic in their regulation. The “international super-regulator” still remains unpopular amongst most regulators.

⁴ See Attachment 3 for a description of the mandates of the Financial Stability Forum Working Groups.

Finally, there is a sense in which the regulation of domestic securities markets is regarded as manifestations of government policy and they are unlikely to surrender that in the near future.

IOSCO can provide guidance on what is necessary and appropriate in securities regulation. It can help to set standards. It can act as a source of pressure for reform but it cannot bring about reform and, in my view, that is unlikely to change in the short term. It will be left to other fora, perhaps including the Financial Stability Forum, to add to the reform pressure. The markets will, one hopes, add further pressure through their evaluation and pricing of risk. It will then be a matter of the resolve of domestic governments.

May 18, 1999

VIP\APWN\9P142

General Information on IOSCO

The member agencies currently assembled together in the International Organization of Securities Commissions have resolved, through its permanent structures:

- to cooperate together to promote high standards of regulation in order to maintain just, efficient and sound markets;
- to exchange information on their respective experiences in order to promote the development of domestic markets;
- to unite their efforts to establish standards and an effective surveillance of international securities transactions;
- to provide mutual assistance to promote the integrity of the markets by a rigorous application of the standards and by effective enforcement against offenses.

The General Secretariat of IOSCO is in Montreal.

The Secretary General is Mr. Peter Clark.

STRUCTURE OF ORGANIZATION

The Presidents' Committee, which meets once a year during the Annual Conference, is made up of all the Presidents of member (regular and associate) agencies and has all the powers necessary or convenient to achieve the purpose of the Organization.

The Executive Committee is presently composed of the following 19 members: the Chairmen of the Technical and Emerging Markets Committees, the Chairmen of each Regional Committee, 1 ordinary member elected by each Regional Committee from among the ordinary members of that region, and 9 ordinary members elected by the Presidents' Committee. The Executive Committee meets periodically during the year and, subject to the By-Laws of the Organization, takes all decisions and undertake all actions necessary or convenient to achieve the objectives of the Organization. Mr. Guillermo Harteneck is currently Chairman of the Executive Committee.

IOSCO has the following four Regional Standing Committees, which meet to discuss specific regional problems of the members of the Organization that constitute them: the Africa / Middle-East Regional Committee, the Asia-Pacific Regional Committee, the European Regional Committee and the Interamerican Regional Committee.

The Executive Committee of the Organization has established two specialized working Committees. The first one, the Technical Committee, is made up of sixteen agencies that regulate some of the world's larger, more developed and internationalized markets. Its objective is to review major regulatory issues related to international securities and futures transactions and to coordinate practical responses to these concerns. Mr. Michel Prada currently acts as Chairman of the Technical Committee. The work of the Technical Committee is divided into the following five major functional subject areas:

- Multinational Disclosure and Accounting;
- Regulation of Secondary Markets;
- Regulation of Market Intermediaries;
- Enforcement and the Exchange of Information;
- Investment Management.

The Technical Committee has set up specialized Working Groups to address each of the above mentioned subject areas. The members of these Working Groups meet several times during the year and tackle, almost on a continuous basis, the mandates that they receive from the Technical Committee.

The second specialized Committee, the Emerging Markets Committee, endeavors to promote the development and improvement of efficiency of emerging securities and futures markets by establishing principles and minimum standards, preparing training programs for the staff of members and facilitating exchange of information and transfer of technology and expertise. The Emerging Markets Committee is currently chaired in an acting capacity by Mr. Paul Melly. It has set up Working Groups to address the following functional areas:

- Disclosure and Accounting;
- Regulation of Secondary Markets;
- Regulation of Market Intermediaries;
- Enforcement and the Exchange of Information;
- Investment Management

Self-Regulatory Organizations (SROs), that are affiliate members of the Organization, are members of the SRO Consultative Committee, which is currently chaired by Mr. Joseph J. Oliver. IOSCO recognizes the importance of maintaining a close dialogue with the SROs and international organizations that make up its affiliate membership and of allowing them to make a constructive input in the work of the Organization. The SRO Consultative Committee has designated contact persons with the Technical Committee Working Groups and is therefore able to provide substantive input related to their regulatory initiatives.

IOSCO has an Internet Home Page where public information about the Organization can be found. The members also have access to specialized

databases through this Web page.

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An **IOSCO** Public Document:

Objectives and Principles of Securities Regulation



Foreword and Executive Summary

This document sets out 30 principles of securities regulation, which are based upon three objectives of securities ¹ regulation. These are:

- The protection of investors;²
- Ensuring that markets are fair, efficient and transparent;
- The reduction of systemic risk.

The 30 principles need to be practically implemented under the relevant legal framework to achieve the objectives of regulation described above. The principles are grouped into eight categories.

A. Principles Relating to the Regulator

- 1 The responsibilities of the regulator should be clear and objectively stated.
- 2 The regulator should be operationally independent and accountable in the exercise of its functions and powers
- 3 The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.
- 4 The regulator should adopt clear and consistent regulatory processes.
- 5 The staff of the regulator should observe the highest professional standards including appropriate standards of confidentiality.

B. Principles for Self-Regulation

- 6 The regulatory regime should make appropriate use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, to the extent appropriate to the size and complexity of the markets.
- 7 SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.

C. Principles for the Enforcement of Securities Regulation

8 The regulator should have comprehensive inspection, investigation and surveillance powers.

9 The regulator should have comprehensive enforcement powers.

10 The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.

D. Principles for Cooperation in Regulation

11 The regulator should have authority to share both public and non-public information with domestic and foreign counterparts.

12 Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.

13 The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers.

E. Principles for Issuers

14 There should be full, timely and accurate disclosure of financial results and other information that is material to investors' decisions.

15 Holders of securities in a company should be treated in a fair and equitable manner.

16 Accounting and auditing standards should be of a high and internationally acceptable quality.

F. Principles for Collective Investment Schemes

17 The regulatory system should set standards for the licensing and the regulation of those who wish to market or operate a collective investment scheme.

18 The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.

19 Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.

20 Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme.

G. Principles for Market Intermediaries

21 Regulation should provide for minimum entry standards for market intermediaries.

22 There should be initial and ongoing capital and other prudential requirements for market intermediaries.

23 Market intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interests of clients and under which management of the intermediary accepts primary responsibility for these matters.

24 There should be procedures for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.

H. Principles for the Secondary Market

25 The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight.

26 There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.

27 Regulation should promote transparency of trading.

28 Regulation should be designed to detect and deter manipulation and other unfair trading practices.

29 Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.

30 The system for clearing and settlement of securities transactions should be subject to regulatory oversight, and designed to ensure that it is fair, effective and efficient and that it reduces systemic risk.

Footnotes:

1. For convenience, in this document, the words "securities markets" are used, where the context permits, to refer compendiously to the various market sectors. In particular, where the context permits they should be understood to include reference to the derivatives markets. The same applies to the use of the words "securities regulation". (See IOSCO By-Laws, Explanatory Memorandum).

2. The term "investor" is intended to include customers or other consumers of financial services.

Press Releases

FINANCIAL STABILITY FORUM

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Press release

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Ref. No.: 19/1999E

11 May 1999

Financial Stability Forum establishes Working Groups

Subsequent to its meeting in Washington on 14 April, the Financial Stability Forum has issued terms of reference for and appointed chairmen of three ad hoc working groups:

- A group chaired by Mr Howard Davies, Chairman of the UK Financial Services Authority, has been asked to recommend actions to reduce the destabilising potential of institutions employing a high degree of leverage (HLIs) in the financial markets of developed and developing economies;
- A group chaired by Mr Mario Draghi, Director General of the Italian Treasury, has been asked to evaluate measures in borrower and creditor countries that could reduce the volatility of capital flows and the risks to financial systems of excessive short-term external indebtedness;
- A group chaired by Mr John Palmer, Superintendent of Financial Institutions, Canada, has been asked to evaluate the impact on global financial stability of the uses made by market participants of financial offshore centres, and the progress made by such centres in enforcing international prudential standards and in complying with cross-border information exchange agreements.

The working groups comprise officials of developed and developing market economies, international financial institutions and supervisory groupings, and will draw on work completed or under way in various public and private sector forums. They will report on their work to the Forum's next meeting in September.

The Financial Stability Forum was initiated by the G7 Ministers and Governors in February this year, based on a recommendation by Mr Hans Tietmeyer, President of the Deutsche Bundesbank. The Forum is chaired by Mr Andrew Crockett, General Manager, Bank for International Settlements.

**Reform of Securities Regulatory Regime in
China: the Securities Law of 1998 (draft)**

Dr. Zhang Xian Chu

Reform of Securities Regulatory Regime in China: the Securities Law of 1998 (draft)

Xian Chu Zhang*

On 29 December 1998 the Standing Committee of the National People's Congress adopted the first Securities Law of the PRC, which will become effective on 1 July 1999. The passage has not only punctuated the bumping legislative history of six and a half years,¹ but also established the first precedent of expert legislation.² More importantly, as the eight-year operation of securities markets in China without an uniform national legislation³ comes to an end, the legislation clearly reflects the firm commitment of the Chinese Government to a market economy and its orderly development and will lay a foundation for a new round of reform.

The newly adopted Securities Law has 214 articles in 12 chapters. In terms of number of articles, the final version has been increased considerably as compared with the draft of October 1998 with only 156 articles in 11 chapters.⁴ However, in terms of content, some articles do no more than codifying the existed rules, which include the Interim Provisions on Stock Issuing and Trading Administration of the State Council of 1993 ("IPSITA") and other government regulations as the current regulatory framework on a provisional basis. As such, the examination of this paper will focus on those new provisions and major breakthrough.

1. General principles

The legislative purposes are stated in Article 1 as to standardize issuing and trading activities, to protect lawful rights and interests of investors, to safeguard the social and economic order as well as public interests, and to promote the socialist market economy.

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¹ The first drafting group of Securities Law was form in as early as August 1992. During the six and a half years, more than a dozen of drafts were produced; the drafting group was re-staffed; and the submission of the draft failed to pass the national legislature's review for four times.

² In a socialist country like China, virtually all the draft laws are put before the national legislature for adoption from the government branches concerned. As such, they inevitably reflect more the government desires than any other interested groups. However, the Securities Law is the first law drafted by scholars, professionals and practitioners as an independent force. Wang Lianzhou: Preface in the Drafting Group of Securities Law, *Securities Law of the PRC – An Annotation*, Reform Publishing House, 1999, at 3 (in Chinese). During the drafting, many foreign experts were also involved in form of international conferences or consultation meeting in China. For a recent publication of these conference papers of American and Canadian as well as Chinese judges, law professors and lawyers, see Shan Changzong (ed.), *Studies of Chinese and Foreign Securities Law and Futures Trading Law and Case Analysis*, People's Court Publishing House, 1997 (in Chinese).

³ According to Professor Li Yining, the head of the Securities Law drafting group, 251 pieces of enactment were have been adopted by various state authorities before the adoption of the Law. However, most of them are of administrative nature on a provisional basis. Jingxun Data of 12 November 1998, Li Yining on Adoption of Securities Law, available at <http://www.chinainfobank.com> (in Chinese).

⁴ Roman Tomasic, An Overview and Assessment of the Draft Securities Law of the People's Republic of China, 9 *Australia Journal of Corporate Law* 284 (1998), at 288.

Thus, any issuing and trading activities shall be governed by the principles of openness, fairness and justice.⁵

The Law does not define the term of securities and simply provides that it will govern issuing and trading of stocks, company bonds and other securities determined by the State Council within mainland China. However, two important exceptions should be noted. Issuing and trading of state treasury bonds may not be subject to the provisions of the Law, but some special legislation;⁶ nor are issuing and trading of B shares which are investment means exclusively available to foreign investors.⁷ Moreover, the Law does not touch any legal issues concerning overseas listing China-funded companies. Although it has been agreed that the term of "other securities" may include financial bonds, bonds of investment funds and convertible debentures,⁸ the contents of the Law cover only stocks and company bonds with permission for the State Council to include more in the future.⁹ Article 4 states that the parties in securities issuing and trading shall have equal footing and abide by the principles of voluntariness, compensation, honesty and trustworthiness.

Article 6 stipulates that securities industry shall be operated and regulated separately from banking, trust and insurance business. Firms in these types of business are required to establish themselves separately. The provisions reflect the government's deep worry about potential financial risks, particularly after the Asian financial crisis. According to a top legislature officer, the regulation of the Chinese securities market must draw lessons from the crisis in international financial market. Although the Law should coordinate itself with the reform in China and adapt itself to the international standards, more attention should be paid to the protection of financial safety in China.¹⁰

The Law authorizes the securities regulatory organ under the State Council shall conduct centralized and unified supervision and regulation over the securities markets of the nation in accordance with law. It may also establish, and delegate its powers to, its local branches.¹¹ In this regard, the provision is intended to codify the restructuring of the securities regulatory authority in October 1998, where the two-tier structure of the SCSC and the CSRC as well as the powers in market regulation shared by both central and local governments has been merged into a single vertical system.¹² As such, SCRC becomes the only state organ under the State Council in charge of securities market supervision and regulation.

⁵ Article 3 of the Securities Law.

⁶ *Ibid*, Article 2.

⁷ *Ibid*, Article 213, which provides that the concrete rules governing B share issuing and trading shall be separately promulgated by the State Council. For a comment, see Jackie Lo, New PRC Securities Law Fails To Fully Unify Regulation of Securities Issues in China, February (1999) *China Law & Practice*, at 21-24.

⁸ Li, *supra* note 3.

⁹ Article 2 of the Securities Law.

¹⁰ Li Fei, China Promulgates First Securities Law, March (1999) *China Law* 58, at 59.

¹¹ *Ibid*, Article 7.

¹² For a detailed report, see A Standard CSRC to Shape Up, *China Economic News*, 16 November 1998, at 3.

2. Securities issuing

Any public issuing of securities must be either authorized or approved by the CSRC.¹³ In case of public issuing of stocks, the relevant provisions of the Company Law must be complied with and the authorization (“*Hezhun*”) of the CSRC must be obtained. On the other hand, issuing of corporate debentures requires CSRC’s approval (“*Pizhun*”). The CSRC shall establish an issuing examination committee, which is composed of both CSRC professionals and outside experts, to formulate its examination opinion on an issuing application by voting,¹⁴ subject to the CSRC’s final approval through open proceedings.¹⁵ The decision shall be made by the CSRC or other authorities designated by the State Council within three months of its receipt of the issuing application.¹⁶

However, the law fails to articulate the applicable legal standards and difference between authorization and approval, although the required application documents for issuing as provided in the IPSITA seem unchanged. It is interesting to note that two legislative bodies provide contradictory interpretations on this important issue after the promulgation of the Law. According to the drafting group, the authorization refers to only procedural examination by the state authority of an issuing application.¹⁷ However, the Research Office of the General Office under the Standing Committee of the National People’s Congress holds that what authorization intends is strict substantive examination in order to prevent securities of poor quality from entering into the market and to protect investors.¹⁸ The legislative history seems to endorse the position taken by the Drafting Group. In the last draft the CSRC was still empowered to approve securities issuing and listing. Nevertheless, the harsh criticism from the legislators against the CSRC’s excessive power without sufficient checking and balance forced the last minute retreat from approval to authorization.¹⁹ As such, the authorization seems to suggest something between the strict approval in the old days and free style registration in a jurisdiction like the US.

The law imposes more responsibilities on the issuer, securities professionals and investors respectively. Article 13 stipulates that the documents provided by the issuer to the state authority must be true, accurate and complete. The professional firms and professionals who produce such documents for the proposed issuing are under a legal duty to ensure the compliance with the same standards. Further, Article 19 warns investors that any change of issuer’s operation or profit after the issuing is only answerable by the issuer and any investment risk caused by such a change shall be borne

¹³ *Ibid*, Article 10.

¹⁴ *Ibid*, Article 14.

¹⁵ *Ibid*, Article 15.

¹⁶ *Ibid*, Article 16.

¹⁷ Drafting Group, *supra* note 2, at 53.

¹⁸ Writing Group of the Research Office of the General Office under the Standing Committee of the National People’s Congress: *Application Guide of Securities Law of the PRC*, Reform Publishing House, 1999, at 75 (in Chinese).

¹⁹ The Research Office of the General Office under the Standing Committee of the NPC, A Review of the Focused Issues in Examination of the Draft Securities Law, 91 *Securities Market Weekly* 1998 (4 November 1998), at 5 (in Chinese)

by investors themselves. Such a legal provision clarifies some confusion with the IPSITA, which requires an issuer to print on the cover page of its prospectus a statement that the issuing approval by the state authority shall not be deemed as its substantive judgment or guarantee for the value and return of the stock.²⁰

Article 18 allows the CSRC and other authorities concerned to take actions to correct their mistakes. For example, an authorization of issuing shall be revoked if the decision is found not complied with the laws and regulations; where the issuing is yet made, it shall be suspended; if the securities have been issued, the holders are entitled to the return of the issuing price paid with the interest from the issuer. The Law, however, does not set out any liability of the CSRC and other authorities for their own mistakes in the process of authorization or approval.

Public issuing shall be underwritten by securities companies that are selected by the issuer at its free will in accordance with the law. The underwriting agreements in forms of either best efforts to sell the securities during the underwriting period as the issuer's agent or firm commitment to purchase all the securities offered by securities companies for the purpose of resale to the public.²¹ Where the face value of the securities to be publicly issued exceeds RMB 50 million, an underwriter syndicate must be formed.²² In any event, underwriters are under a legal duty to examine the issuing documents for their truthfulness, accuracy and completeness. Once any false record, misleading statement or significant omission is found, the sales may not be conducted; where the sales have started, they must stop with corrective measures being taken.²³ Article 22 of the IPSITA mandates syndicate underwriting if the face value of the issuing to be made exceeds RMB 30 million or the projected sale proceeds exceed RMB 50 million. In comparison, the new Law is much clearer.

An underwriting period may not exceed 90 days. The underwriters shall file a sales report with the SCRC for record within 15 days of the expiration of the underwriting period.²⁴ Where stocks are issued at a premium, the price may be determined by the issuer, together with the underwriters; however, the final authorization of the CSRC must be obtained before the issuing is made.²⁵

3. Securities trading

(1) Securities to be traded must be legally issued ones²⁶ and any trading of listed securities must be conducted on the stock exchanges²⁷ and the Law fails to inaugurate the opening the over-the-counter ("OTC") market in China. The OTC market has been

²⁰ Article 16 of the IPSITA.

²¹ Articles 21 and 22 of the Securities Law..

²² *Ibid*, Article 25.

²³ *Ibid*, Article 24.

²⁴ *Ibid*, Articles 26 and 27.

²⁵ *Ibid*, Article 28.

²⁶ *Ibid*, Article 30.

²⁷ *Ibid*, Article 32.

considered as a very important part of the Chinese securities market.²⁸ However, recently, the CSRC has openly denied any plan in the near future to open any NASTAQ-type OTC market in China.²⁹ Also, securities may not be traded on the basis of credit, but must be on spot transaction³⁰ and securities companies are prohibited from providing any finance or lending any securities to their clients for trading.³¹

Under the law, certain people are prohibited from directly or indirectly owning or trading any stocks or accepting any stocks from others during their term of office or tenure. They include staff of securities exchanges, securities companies, securities registration and settlement institutions; officials of the securities regulatory authorities; and others who may not engage in trading under the law, such as the current directors of the company.³² Any stocks already owned by these persons prior to the implementation of the Law must be transferred in accordance with the law.³³ Article 39 further provides that the institutions that produce auditing reports, asset appraisal reports or legal opinions for an issuer shall not purchase or sell the stocks concerned during the underwriting period and six months thereafter; nor purchase or sell the stocks concerned during the period from the date on which the issuer's appointment for the service is accepted to the fifth day of the publication of the issuing documents concerned. Both bans aim at preventing insider trading.

Article 41 requires a shareholder to notify the issuer within three days when his holding reaches 5 percent of the company's common stocks issued; in turn, the company shall file report within three days to the CSRC, and the exchange concerned if the company is listed. Such a report is designed to enable the state authority and the exchange to monitor transactions of big shareholders. For instance, any profit of short swing made by a 5 per cent or more shareholder from trading of his stocks held less than six months shall be accounted to the company and should be recovered by its board of directors. Where the board fails to do so, the Law entitles any shareholder to make such demand and subject the board and responsible directors to joint liability to the company. However, a securities company which holds 5 per cent or more stocks of the issuer under a firm commitment arrangement is exempted.³⁴

²⁸ Both domestic and foreign experts believe China's over-the-counter market may prove to be even greater long-term significance in development of the Chinese securities market. See Yang Zhihua, *A Study of Securities Legal Regime*, China University of Political Science and Law Press, 1995, at 246-7 (in Chinese); and Geoffrey Nicoll, *Philosophy, Law and Practice in the Market for Chinese Securities*, 9 *Australia Journal of Corporate Law* (1998), at 341.

²⁹ See the report on *Ming Pao*, 22 April 1999, B13. It has been observed that the CSRC has taken a hostile attitude to the OTC market from the perspective of government control for a long time. William D. Holmes, *China's Financial Reforms in the Global Market*, 28 *Law & Policy in International Business* (1997) 715, at 751-752.

³⁰ Article 35 of the Securities Law.

³¹ *Ibid.*, Article 36.

³² Article 147 of the Company Law stipulates that directors, supervisors and managers of a company shall not transfer their shares during their terms.

³³ Article 37 of the Securities Law.

³⁴ *Ibid.*, Article 42.

(2) Listing of any company stocks must be authorized by the CSRC. However, such a power may be delegated to the exchange concerned.³⁵ The application documents specified by Article 45 include listing application, the relevant resolution of the shareholders' meeting, the articles of association of the company, its business registration, financial and accounting reports audited by accredited institutions, legal opinions, recommendation letter of the securities firms, and the latest prospectus.

Under Article 46, the exchange concerned shall make arrangement to list the company that has received authorization from the CSRC within six months of receipt of its application documents. With the consent of the exchange, the listing documents shall be published by the issuer five days before the public trading and placed at the designated place for public inspection.³⁶ In addition, the issuer is required to publish the trading date approved, the top ten shareholders and their respective holdings and the names of directors, supervisors, managers and other senior officers of the issuer as well as their holdings.³⁷

Listing of corporate bonds shall be approved by the CSRC, or the exchange concerned with the CSRC's authorization³⁸ subject to the procedures similar to stock listing, except that the time for listing arrangement is shortened to three months.³⁹ Moreover, Article 51 sets out the substantive standards for corporate bond listing to include: (1) the term of the listed bonds being longer than a year; (2) the actual issued value being no less than RMB 50 million; and (3) the company, while applying for listing, meets other conditions provided by other laws and regulations.⁴⁰

In addition to bankruptcy, the CSRC may decide to suspend or terminate the listing of a company's securities, if the company is found to have seriously violated the law, to have had significant change of its conditions so as to render it no longer to meet the listing standards, to have failed to use the funds raised in accordance with the approved purpose, to have failed to carry out its legal obligations under the issuing conditions, or to have suffered losses for recent two consecutive years.⁴¹ Article 57 further allows the CSRC to delegate its power to suspend or terminate listing of company stocks or bonds to the exchanges concerned.

(3) Any listed company shall be under a legal duty of continuous disclosure. Under the law, a listed company must file with the CSRC and the exchange concerned, and to publish, its mid-term report within two months of the conclusion of its first half accounting year and its annual reports within four months of the conclusion of its

³⁵ *Ibid*, Article 43.

³⁶ *Ibid*, Article 47.

³⁷ *Ibid*, Article 48.

³⁸ *Ibid*, Article 50.

³⁹ *Ibid*, Articles 52, 53 and 54.

⁴⁰ For example, Article 161 of the Company Law provides a series of conditions for issuing company debentures, including the quantity of the assets of the company concerned, the ratio between the debenture and its net assets, the profit level of the past three years, compliance with the state industrial policy and the interest ceiling.

⁴¹ Articles 55 and 56 of the Securities Law.

accounting year. In addition to the common requirements to disclose the financial and operational conditions and other items required by the CSRC, a mid-term report has to cover the major litigation the company involved, the change of the stocks or bonds, and important matters proposed to the shareholders' meeting;⁴² whereas an annual report needs to include the information of the directors and other senior officers, the top ten shareholders and their respective holdings.⁴³

Moreover, according to Article 62, a company must file and publish a special report with explanation when any major event that may have impacts on the price of its stocks and is unknown to public investors occurs. The Article further articulates the major categories of these events: (1) significant change of the company's operation policy and business scope; (2) its important investment or decisions of asset purchase; (3) its conclusion of any important contract which may significantly affect the company's assets, liabilities, interests and operation result; (4) its incurring or default of major debts; (5) its significant deficit or major loss that exceeds 10 per cent of its net assets; (6) significant change of the external environment of its business operation; (7) change of chairman of its board of directors, one-thirds of directors or managers; (8) major change of the holdings of the shareholders who own 5 per cent or more the company's stocks; (9) any decisions of the company on reduction of its capital, merger, division, dissolution or bankruptcy application; (10) its involvement in any major litigation or the court's order to annul any resolution of the shareholders' meeting or the board of directors; and (11) other matters required by other laws or regulations.

As far as special reports are concerned, a very important deletion should be noted. According to Article 60 of the IPSITA, a special disclosure may not be made under the exchange's approval if the listed company has sufficient reasons to believe that the disclosure would harm the company's interests and that the non-disclosure would not lead significant price fluctuation of the market. Since the new Law includes no such an exception, the duty of disclosure appears unconditional.

The listed company is responsible for the truthfulness, accuracy and completeness of its issuing and listing documents and shall ensure there is no false record, misleading statement or significant omission.⁴⁴ The issuer and the underwriters shall be liable for the loss of the investors caused by such violations in the company's issuing prospectus, financial and accounting report, listing report, annual report, mid-term report, or special reports. The responsible directors, supervisors and managers shall be held jointly liable together.⁴⁵

(4) The law prohibits insider trading, market manipulation, making and spreading false information and any other fraudulent conducts against investors.⁴⁶

⁴² *Ibid*, Article 60.

⁴³ *Ibid*, Article 61.

⁴⁴ *Ibid*, Articles 59.

⁴⁵ *Ibid*, Article 63.

⁴⁶ *Ibid*, Articles 5, 67, 71, 72 and 73.

Article 68 defines the following persons as statutory insiders: the directors, supervisors, managers, deputy managers and other senior officers concerned of the issuer; shareholders with 5 per cent or more holdings; the senior officers of the issuer's holding company; staff who have access to inside information by virtue of their positions in the company; staff of the securities regulatory authorities and other staff under legal duty to administer securities trading; staff of intermediaries, securities registration and settlement institutions and securities trading service firms that are involved in the company's trading under their legal duties; and other persons prescribed by the CSRC.

The enumerative approach is also used to define inside information in Article 69. In addition to the information listed in Article 62 aforementioned for triggering a filing of special reports, Article 69 further adds the following: company's plan to distribute dividend or increase capital; significant change of its share holding structure; significant change of its debt security; the major mortgage or sales of the company's major operational assets or scrapping of its assets exceeding 30 per cent of the total at one time; potential major liability to be borne by the senior officers of the company under the law; any take-over plan of the listed company; and other information that the CSRC believes to have notable impacts on the trading price of the securities.

Under the law, insiders and other persons who have unlawfully obtained inside information are prohibited from purchasing or selling the securities of the company concerned, or disclosing the information, or suggesting others to trade the securities. However, the ban may not apply to the acquisition by a shareholder with 5 per cent or more stocks of the company.⁴⁷

As compared with the Interim Provisions against Securities Fraud issued by the SCSC in 1993, the number of items classified as inside information in the Law decreased. Some categories, including change of state policy, change of company's articles of association, registered capital or registered address, and dishonouring of company's large cheque, are either deleted or merged into other classes. In terms of insider definition, the approach of the Law is more general.⁴⁸ Moreover, since Article 70 of the Law only prohibits insiders or others who unlawfully obtain inside information from trading, disclosing or advising others to trade, it seems not clear to what extent tippees' liability will be enforced.

Article 71 sets out the forbidden means of unlawful manipulation of the market: manipulating the securities trading price individually or conspiratorially by taking advantage of the superiority of capital, holdings or information, or by consecutive trading; affecting trading price or volume by trading at the pre-arranged time, price or means between the conspirators or by trading the securities that are not owned by them between them; affecting trading price or volume through self-dealing and trading without change ownership; and other manipulative means.

⁴⁷ *Ibid.*, Article 70.

⁴⁸ Article 6 of the Interim Provisions explicitly includes the following as insiders: secretaries, typist and other staff of the issuer who may have access to inside information; professionals involved in issuer's business; staff in government authorities of market regulation and taxation; journalists, editors, printing staff and other persons who may have access to inside information.

Under Article 72, government functionaries, employees of mass media and other persons concerned are forbidden from making or disseminating false information that will seriously affects securities trading. Moreover, the exchanges, securities companies, securities settlement institutions, securities service firms, social intermediates, securities business association, securities regulatory authorities and their staff are banned to make any false statement and to mislead investors in securities trading activities. Securities trading information disseminated by mass media is also required be true, objective and not misleading.

Fraudulent activities of securities firms and their staff that are prohibited by Article 73 include: trading securities against the client's trust; failure to provide affirmative documents of trading within the stipulated time; misappropriation of clients' entrusted securities or funds; trading client's securities or using clients' name to trade securities without permission; inducing clients to conduct unnecessary trading for the purpose of commission making; and other conducts that violate clients' true will and interests.

In addition, some rules are stipulated to prevent state funds from being risked in securities speculation. For example, legal persons are prohibited from trading through private individual accounts;⁴⁹ no person shall use public fund to conduct securities trading,⁵⁰ and state-owned enterprises and holding companies of state assets are banned to speculate on securities market.⁵¹ Article 77 further requires the exchanges, securities companies, securities registration, trading service and intermediary institutions and their employees to report to the CSRC any violation they notice.

4. Acquisition of listed company

Article 78 sets out two ways of acquisition: acquisition by tender offer and acquisition by agreement. An investor shall file a written report with the CSRC and the exchange concerned and publish it within three days when his holding of a listed company amounts to 5 per cent as the result of his trading. During this period, he may not continue his trading of the securities concerned. Afterwards, such an investor is required to make filing and publication for his holding fluctuation of every 5 per cent. During the reporting period and within two days of the publication, his trading of the securities must pause.⁵²

Once the investor's holding reaches 30 per cent of the issued stocks of the listed company as the threshold, a tender offer shall be made to all shareholders in accordance with the law, if he intends to carry on the acquisition. However, the CSRC may exempt such requirement for tender offer,⁵³ which would be surely needed to release the state from the mandatory purchase due to its heavy holdings of most listed companies.⁵⁴

⁴⁹ *Ibid*, Article 74.

⁵⁰ *Ibid*, Article 75.

⁵¹ *Ibid*, Article 76.

⁵² *Ibid*, Article 79.

⁵³ *Ibid*, Article 81.

⁵⁴ Currently, in two-third of listed companies, the holdings of the state or state-owned legal persons amount to 60-70 per cent. See *State Owns Too Big in Listed companies – An Interview with Liu Shabo of*

Before any tender offer is made, the acquirer must submit an acquisition report to the CSRC and the exchange with detailed information of the purpose, quantity, terms and funds involved of the acquisition.⁵⁵ The tender offer shall be published 15 days after the submission of the acquisition report. The length of the period of a tender offer shall not be less than 30 days, nor longer than 60 days.⁵⁶ At the end of the period, trading of the target company's stocks will be terminated if the acquirer's holding amounts to more than 75 per cent of the company's total issued shares;⁵⁷ a 90 per cent holding of the acquirer during the period further entitles the rest of shareholders to a mandatory purchase by the acquirer on the same terms of the tender offer.⁵⁸

The most notable change in acquisition on securities market is the stretch of the interval of the progress report from 2 per cent under the IPSITA,⁵⁹ which was copied from the Securities Exchange Act of 1934 of the US,⁶⁰ to 5 per cent. The legislative purpose is to lower the acquisition cost and to further facilitate optimum allocation of resource since under the new Law only six reports, instead of 13, need to be made by an acquirer before his holdings reach the 30 per cent threshold.⁶¹ Also, Article 84 stipulates that during the tender offer period, the acquirer shall not withdraw its tender offer and any change of offer terms must be approved by the CSRC and the exchange concerned. As such, the IPSITA rule that allows the acquirer to change terms during the tender offer period so long as the notification is given⁶² is abolished.

Under Article 89, the acquirer and the shareholders may by agreement transfer the shares in accordance with the law and regulations concerned. Upon the agreement being reached, the acquirer must report the agreement in writing to the CSRC and the exchange within three days and publish it at the same time. Performance of the agreement shall not be carried out until the publication is made.⁶³ According to the drafting group, this article is designed to liquidize state shares and state-owned legal person shares between different state owned entities by agreement in a condition that trading of these shares are not allowed on the market.⁶⁴

In either way of acquisition, the acquirer may not transfer the shares purchased within six months of the completion of the acquisition⁶⁵ and any purchase of state shares must be approved by the state authority concerned.⁶⁶ Article 93 further requires the acquirer to

Guangdong Securities Association, *China Economic News*, 10 November 1997, at 6-7.

⁵⁵ Article 82 of the Securities Law.

⁵⁶ *Ibid*, Article 83.

⁵⁷ *Ibid*, Article 86.

⁵⁸ *Ibid*, Article 87.

⁵⁹ Article 47 of the IPSITA.

⁶⁰ See Section 13(d) of the Securities Exchange Act of the US.

⁶¹ See the report entitled Agreement Has Been Reached on How to Borrow the International Standards; *People's Daily*, 23 November 1998 (in Chinese).

⁶² Article 52 of the IPSITA.

⁶³ Article 89 of the Securities Law.

⁶⁴ Drafting Group, *supra note 2*, at 167.

⁶⁵ Article 91 of the Securities Law.

⁶⁶ *Ibid*, Article 94.

report to the CSRC and the exchange the result of the acquisition within 15 days of its completion, and to publish it.

5. Securities exchanges

Article 95 defines an exchange as a non-profitable legal person who provides the centralized venue for collectively securities trading by bidding. Establishment or dissolution of any exchange must be approved by the State Council and the adoption and revision of articles of any exchange must be approved by the CSRC.⁶⁷ According to Articles 99 and 100, the council of the exchange and the general manager who is appointed by the CSRC shall head an exchange. Articles 101 and 102 further disqualify certain persons to be in charge of an exchange and to be employed by an exchange. As part of restructuring regulatory regime, the Law subjects exchanges to the firm control of the central government.⁶⁸

It is the legal duty of the exchange to safeguard fairly trading by bidding and promptly publish the trading information.⁶⁹ The exchange is empowered to handle suspension, resumption or termination of listing of any stocks and debentures in accordance with the law⁷⁰ and may suspend trading in case of certain sudden incidents or *force majeure* situation.⁷¹ It shall also monitor trading in the exchange, report to the CSRC any abnormal trading and supervise information disclosure of the listed companies.⁷²

An exchange is responsible under Article 113 for formulating its concrete trading rules, membership provisions and working procedures for its staff, subject to the approval of the CSRC. Persons in charge of exchange operation and other employees shall withdraw if there proves a conflict of interest involving themselves or their relatives in the course of performing their duties.⁷³ The exchange may discipline their staff for violation of trading rules with the means up to disqualification.⁷⁴

6. Securities companies

Establishment of any securities company, which may be in form of either a limited liability company or a joint stock company, must be examined and approved by the CSRC.⁷⁵ Such approval shall also be needed for its branch setting-up or dissolution, change of its business scope or registered capital, amendment to its articles, its merger or

⁶⁷ *Ibid*, Article 96.

⁶⁸ According to Article 4 of the Interim Provisions on Securities Exchange Administration of SCSC 1993, the power to regulate and supervise exchanges shall be shared by the CSRC and the local governments concerned.

⁶⁹ Article 107 of the securities Law.

⁷⁰ *Ibid*, Article 108.

⁷¹ *Ibid*, Article 109.

⁷² *Ibid*, Article 110.

⁷³ *Ibid*, Article 114.

⁷⁴ *Ibid*, Article 116.

⁷⁵ *Ibid*, Articles 117 and 118.

division, change of its business form or dissolution.⁷⁶ Under Article 119, securities companies are divided into two categories: multiple-function securities company (“MFSC”) and securities brokerage company (“SBC”) with different business licenses.

The conditions to establish a MFSC include that it has minimum registered capital of RMB 500 million; its principal management and business staff must be qualified; it has fixed business place and infrastructure that meets the standards; and it has sound management system and standardized setup that separates its own securities operation and its brokering business.⁷⁷ On the other hand, the minimum registered capital of a SBC is RMB 50 million, with other conditions of staff qualification and infrastructure being similar to a MFSC.⁷⁸ Where the registered capital of a securities company falls below the minimum statutory requirement, the CSRC may revoke the approval to its business operation.⁷⁹

In terms of business, a MFSC is entitled to operate securities brokering business, its own securities operation, securities underwriting and other securities business approved by the CSRC,⁸⁰ whereas a SBC may only engage in securities brokering.⁸¹ Securities companies are prohibited by Article 131 from conducting any business beyond their approved scope.

Although Article 135 provides that each securities company shall enjoy its autonomy of business operation and its lawful business shall be free from any intervention, the law articulates many business restrictions for securities companies. Article 124, for example, stipulates that the CSRC shall adopt regulation governing the ratio between the total debts of a securities company and its net assets and the ratio between its total liquid debts and its total circulating assets. Article 132 states that clients’ funds of settlement must be deposited in full into each individual’s account with a designated commercial bank. A securities company is forbidden to appropriate such funds. Article 133 further stipulates that a MFSC’s own securities business must use its own capital or funds raised in accordance with the law.⁸² Funds from banks are prohibited from flowing into the securities market in violation of law. Also, a MFSC must use its own name in conducting its own securities business and its own securities account may not be lent out.⁸³ Article

⁷⁶ *Ibid*, Article 123.

⁷⁷ *Ibid*, Article 121.

⁷⁸ *Ibid*, Article 122.

⁷⁹ *Ibid*, Article 136.

⁸⁰ *Ibid*, Article 129.

⁸¹ *Ibid*, Article 130.

⁸² Actually, there is no law in this area. Since the Securities Law fails to tell how total 88 securities companies in the mainland China with their own capital in total of less than RMB 20 billion can be able to keep up with the liquidity and further expansion of the securities market with the current market value of RMB 2 trillion under many government restrictions. See the report entitled *The First Securities Law Adopted*, *Ming Pao*, 30 December 1998, at B15 (in Chinese). Currently, the CSRC is considering some measures to deal with the problem, such as establishing some special financial institutions to raise capital for securities companies or allow these companies to have access to the bond market or inter-bank borrowing market. Meanwhile, the drafting group of the Securities Law now has been assigned to draft the Investment Fund Law. *Ming Pao*, 27 January 1999, at A16.

⁸³ Article 134 of the Securities Law.

106 provides that securities purchased by a securities company, regardless of its clients' order or for its own business, shall not be re-sold on the same day.

According to Article 138, in conducting brokering business, a securities company has to open and manage a securities account and a capital account for each client separately free of false record. A client account must be opened with the lawful document proving his Chinese nationality or its Chinese legal person status. Any order placed by a client, regardless of being executed or not, must be carefully recorded, examined and kept.⁸⁴ Article 141, again, repeats the rules of Articles 35 and 36: a securities company may only accept a sales order backed with real securities on the client's account and a purchase order backed with real fund on the client's capital account. In other words, it shall provide neither finance, nor securities lending for clients' trading.

Article 142 forbids a securities company to accept full powers of attorney, which would allow the company to decide selling and buying, kinds of securities, quantity and the price for its client. Articles 143 and 144 prohibit a securities company from by any means promising a client for compensation in case of loss or for guaranteed profit, and from taking any client's order outside the lawfully established exchange.

In conjunction with Article 57 of the Company Law,⁸⁵ Articles 125 disqualifies certain persons to be directors, supervisors and managers of a securities company if they are dismissed in recent five years from any securities exchange, securities registration or settlement institutions or securities companies as senior officers due to their violation, or are disqualified in recent five years as professionals due to their violation. Article 126 states that anyone who is dismissed from a securities related entity or a government office due to his violation may not be employed as staff by any securities company. Article 127 bans any government official and others who are prohibited by the laws or regulations from being employed in a company to take positions on a part-time basis with any securities company; senior officers and business staff of a securities company may not take any position in any other securities company. A securities company shall be held fully liable if its staff violates trading rules under the company's instruction or by virtue of his position.⁸⁶

7. Securities registration and settlement institutions ("SRSI")

⁸⁴ A SRSI is defined under Article 146 as a non-profit legal person to provide services of centralized registration, trust and clearing for securities trading. Establishment and dissolution of any SRSI as well as adoption of its articles and business conditions must be approved by the CSRC.⁸⁷ Such an institution, in addition to meeting the requirements for

⁸⁴ *Ibid*, Articles 139 and 140.

⁸⁵ A person is disqualified to be a senior officer of any company under Article 57 of the Company Law if he has no or limited civil capacity; has been convicted for certain crimes; has been responsible as a senior officer for bankruptcy of any enterprise in recent three years; has been a legal representative of a firm whose business license has been revoked for its violation in recent three years; or fails to repay personal debts due of a relatively large amount.

⁸⁶ Article 145 of the Securities Law.

⁸⁷ *Ibid*, Articles 146, 149 and 156.

its infrastructure and personnel qualification, must have its own capital of no less than RMB 200 million.⁸⁸

Article 148 specifies the business scope of a SRSI to include opening of securities and settlement accounts; securities trust and ownership transfer; registration of securities holders' list; settlement and transfer of trading of listed securities in the exchange; distribution of securities gains under the trust of the issuer; handling information inquiry concerning the business aforementioned; and other business authorized by the CSRC. All listed securities to be traded must first be entrusted with a SRSI by the owner before any trading.⁸⁹

For the sake of safe operation, a SRSI is required to establish and improve its necessary service facilities, data protection measures and risk management system.⁹⁰ Any original registration, trust and settlement documents must be duly kept; important ones shall be preserved for no less than 20 years.⁹¹ Further, a SRSI must establish a settlement risk fund for the purpose to compensate any losses caused by technical breakdown, operational mistake and *force majeure* situation.⁹²

8. Securities trading service institutions (“STSI”)

Under Article 157, professional investment consulting firms and credit appraisal firms may be established according to the needs of investment and trading business by following the terms and approval procedures provided by the CSRC.

Business staff of a STSI must have both special knowledge and the business experience of two or more years on a trust basis.⁹³ Article 159 prohibits them from representing clients to conduct securities investment, sharing profit or losses of the securities investment, trading of the stocks of the company that the firm provides its service to, and conducting other activities forbidden by the law.

Article 161 states that a STSI and its staff that produce auditing reports, asset appraisal reports or legal opinions must produce such documents in compliance with professional procedures, and examine and verify their truthfulness, accuracy and completeness. A STSI and its staff concerned shall be held jointly liable for their failure to meet the legal standards due to their fault.⁹⁴

9. Securities trade association

A securities trade association is stipulated by Article 162 as a self-disciplinary organization of securities business with social legal person status. All securities

⁸⁸ *Ibid*, Article 147.

⁸⁹ *Ibid*, Article 150.

⁹⁰ *Ibid*, Article 152.

⁹¹ *Ibid*, Article 153.

⁹² *Ibid*, Article 154.

⁹³ *Ibid*, Article 158.

⁹⁴ *Ibid*, Article 161.

companies are required to join the association and the member assembly shall be its power organ. The articles of association have to be filed with the CSRC for record.⁹⁵

The functions of a securities trade association, under Article 164, include to: assist the CSRC to educate, and organize its members; to abide by the laws and regulations; to uphold the lawful interests of its members in accordance with law and to convey members' suggestions and concerns to the CSRC; to provide its members with information service; to formulate rules of members and to organize training and experience exchange for members; to mitigate disputes between its members or between its members and their clients; to organize its members to study on the issues concerning the development of the trade and its operation; to supervise and inspect its members' conducts and to discipline violators; and to carry out other functions authorized by the CSRC.

10. The securities regulatory and administrative authority

Since the two-tier regulatory structure has been merged into a single organ under the State Council, the CSRC becomes the state authority in exclusive charge of the securities market regulation and administration. Article 167 empowers the CSRC to adopt market regulations and exercise its examination, authorization and approval powers; to supervise and regulate issuing, trading, registration, trust and settlement of securities; to supervise and regulate the business activities of issuers, listed companies, exchanges, securities companies, SRSIs and STSIs; to formulate and implement qualification and professional standards of securities business; to supervise and inspect information disclosure in securities issuing and trading; to supervise and guide the activities of securities associations; to investigate and penalize violations of the Securities Law and other regulations; and to carry out other legal functions.

To the stated ends, the CSRC is provided with extensive powers to take various actions, including actions to collect evidence by entering into the scene of the violation; to make inquiry to entities or individuals concerned with in the investigation; to inspect and duplicate any record of securities trading and transfer registration, financial and accounting materials as well as other documents concerned; to seal them up where they might be removed or hidden; to examine the capital accounts and securities accounts of the entities or individuals concerned; and to apply with the People's Court to freeze them when funds or securities are likely to be illegally transferred or hidden.⁹⁶

To further the strength of the CSRC, Article 171 states that in the course of CSRC's enforcement, the entities and individuals under the investigation must be cooperative, hand out the documents and materials faithfully, and may not refuse, hinder or conceal. Where any activity under the investigation is likely to constitute a crime, the CSRC shall transfer the case to judiciary branches.⁹⁷

⁹⁵ *Ibid*, Article 163.

⁹⁶ *Ibid*, Article 168.

⁹⁷ *Ibid*, Article 173.

Indeed, certain provisions are set out to prevent abuse of power by the CSRC. Article 169, for example, requires CSRC's staff to show the authorization papers while exercising their enforcement power and to bear the duty to keep the commercial secret learned therein confidential. Article 170 provides that staff of the CSRC must faithfully carry out their responsibilities; act in accordance with the law; be just and honest; and not seek any illegitimate interest by taking advantage of their positions. Under Article 172, regulations and working procedures adopted by the CSRC shall be promulgated and its investigation results and disciplinary decisions shall be published. The CSRC's staff may not take any position in institutions or firms under the CSRC's regulation.⁹⁸

Although as compared with the existed regulations, the new Law has made some notable progress in relation to relaxation of the government control in certain areas and to increase of transparency of the relevant procures, the most striking characteristic of the Law is still restrictive, rather than enabling. Having found that almost half of articles of the draft law dealt with the role of the CSRC, Professor Tomasic held that this emphasized the continuation of the heavy regulatory approach in the Chinese securities market and contrasts with the mixed system of public and private regulation in Western jurisdictions.⁹⁹ His view is shared by Professor Jiang Ping, a leading authority in Chinese law, who pointed out that virtually all the rules of the Law are of compulsion, leaving little room for discretion of market players.¹⁰⁰

Indeed, it has been claimed that the CSRC is designed to follow the model of the Securities Exchange Commission of the US ("SEC") which also enjoys very broad powers. However, it should be noted that unlike the SEC as an independent and non-partisan organ responsible for investors' protection,¹⁰¹ the CSRC is a government branch with the primary mission to implement the government financial and industrial policies, rather than investors' protection.¹⁰² Moreover, the excessive government involvement and control on the market has been subjected to little check and balance. Mr. Xu Jialu, one of the Vice Presidents of the Standing Committee of the NPC pointed out that concentration of powers on the CSRC without sufficient checking would easily trigger intervention of the government and the Communist Party on the market and corruption.¹⁰³

11. Legal liabilities

The chapter as the second largest one in the Securities Law includes 36 articles (Chapter 3 Securities Trading is the largest one with 48 articles). They cover every violation of the

⁹⁸ *Ibid*, Article 174.

⁹⁹ Tomasic, *supra* note 4, at 290.

¹⁰⁰ Jiang Ping, The securities Law by Its Nature Is an Regulatory Law; *China Securities*, January 5, 1999 (in Chinese).

¹⁰¹ Louis Loss and Loel Seligman, *Securities Regulation* (3rd ed.), Vol. 1, Little, Brown and Co., (as updated to 1997), at 285-296.

¹⁰² Article 166 states that the CSRC's functions are to implement supervision and regulation on the securities market, to uphold the market order, and to ensure its operation in accordance with the law.

¹⁰³ See his opinion on the draft Securities Law, the Research Office of the General Office of the Standing Committee of the NPC, at 4. His deep concern has been shared by many legislators. *Ibid*, at 4-6.

rules of the law. In terms of nature of the penalties specified, they may be grouped into three categories.

Criminal liabilities are provided in 18 of 33 articles in the chapter carrying substantive penalties and these articles should be read further in conjunction with the relevant provisions of the Criminal Law of 1997, which set out the factors of the offences and sentencing spectrum. Issuing securities without approval, serious violation of disclosure obligation, establishment of a securities company without permission, insider trading, manipulation of market and illegal operation of securities company, SRSI or STSI may all trigger imposition of criminal punishment. The penalties include fine, criminal detention, and imprisonment up to 10 years.¹⁰⁴

Administrative sanctions in forms of warning, order to correct, mandatory disposition, fine, confiscation, outlawing, disqualification, business suspension, revocation of business license, order to close down and other administrative disciplines are deployed in all substantive provisions of the chapter. Most of penalties of this nature may be imposed against all corporate, institutional or individual violators. Article 210 allows the party concerned to petition to the CSRC for a review or to bring a legal action in the court against a CSRC decision to impose sanctions.

In sharp contrast with the extensive criminal and administrative punishment, the application of civil liabilities appears in merely two articles. Article 192 provides that a securities company shall be liable for its violation of the client's trust and true will. Article 202 stipulates that losses suffered from false contents of documents produced by professional firms shall be compensated.¹⁰⁵

The civil compensation regime under the new Law seems to suffer by comparison with the previous rules. For example, the provision in the IPSITA to subject all securities violations causing loss to others to civil liabilities¹⁰⁶ is deleted from the Law. So is the provision of the Interim Provisions on Prohibition of Securities Fraud of 1993 issued by the SCSC, which encourages the public to report securities fraud and other violations with rewards.¹⁰⁷ Also, a call for establishment of an investors' association to protect their own interests¹⁰⁸ was ignored. Apparently, unlike the legal regime in the US where private actions are deemed effective and independent supplements to enforcement of the securities law,¹⁰⁹ the Law of PRC does not consider public investors as a driving force by

¹⁰⁴ See Articles 178-182 of the Criminal Law of 1997.

¹⁰⁵ Article 63 also subjects issuers, underwriters and their senior officers to civil liabilities for their disclosure violations.

¹⁰⁶ Article 77 of the IPSITA.

¹⁰⁷ This provision was considered as a positive development of the Chinese securities law against insider trading and other violations on the awareness of the finite nature of the CSRC's investigative capabilities. Brian Daly, *Of Shares, Securities, and Stakes: the Chinese Insider Trading Law and the Stakeholder Theory of Legal Analysis*, 6 *American University Journal of International Law and Policy* 1996, at 1012.

¹⁰⁸ See the report entitled *Several Issues Concerning the Securities Law*, *Financial Times*, 4 December 1998, at 8 (in Chinese).

¹⁰⁹ Harold S. Bloomenthal and Holme Robert & Owens, *Securities Law Handbook* (1994 ed.), Clark

private actions to enhance the regulatory regime on the securities market, but mere subjects of the government protection in this government monopolized industry.

Further, although Article 207 provides that where a violation subjects the violator to both civil compensation and administrative fine and its assets prove insufficient to pay both, the civil compensation should be paid first. At first glance, the rule seems more concerned with investors' protection. However, the law does not prohibit the state authorities to take priority over investors by means of confiscation of unlawful income. In a recent case dealt by the CSRC, a listed company was found guilty of fraud by fabricating profit and increased capital fund, which made the price of its stock dramatically jumping up by over 10 times in 1996 based on its projected gain of RMB 0.87 per share. However, it turned out that its 1996 profit was only RMB 0.05 per share. After investigation over a year, the CSRC announced its punishments against the company on 29 April 1998. In addition to some personal penalties, unlawful profit of the parties involved of RMB 132.81 million, which was investors' money, was confiscated into the government pocket. As a result, little was left to 107,000 public investors from the badly damaged company and one year suspension of trading.¹¹⁰ Thus, the decision has been criticized by some scholars. Professor Yao Xinhua of China University of Political Science and Law, for example, held that in this case disregard of private right protection would render the law to lose the rightfulness of its own existence.¹¹¹

11. Conclusion

Obviously, it is too early to assess the impacts and implications of the new Law before it is tested in practice. However, the firm commitment of the government to further develop and improve the securities market in China as an important part of its economic reform should first be welcome. In 1992 even the support from the paramount leader Deng Xiaoping for the securities market was cautiously made when he stated that "a firm try should be given to see whether securities and stock market may be used by a socialist regime. If in a year or two the result is positive, we may fully open the market; if it proves wrong, we may just close it down."¹¹² After the vigorous practice for eight years, the tone has been changed upbeatly when President Jiang Zemin held "there will inevitably be securities markets in the practice of a socialist market economy".¹¹³ The

Boardman Callaghan, 1993, at Chapter 14-5. It is noted that in the US, the number of private actions are larger than SEC actions. Richard M. Philips, Paul M. Farion and Brenda P. Murray, *Enforcement of Securities Law in the United States and Canada* in Shan Changzong, *supra note 2*, at 193.

¹¹⁰ The CSRC's decision was published on 4 CSRC's Official Bulletin 1998, at 52-53 (in Chinese). For some relevant facts of the case, see the report on *Southern Weekend*, 7 August 1998, at 6 (in Chinese).

¹¹¹ Xiao Xinhua, *Private Right Remedy for Securities Fraud*, a conference paper presented to China-Australia Links Symposium on Reform of PRC Securities and Insolvency Laws in Beijing on 21-22 September 1998, at 8.

¹¹² Deng Xiaoping, *The Major Points of Speech Made in Wuchang, Shenzhen, Zhuhai and Shanghai in Early 1992*, *Selected Deng Xiaoping's Works*, Joint Publishing (Hong Kong) Co., 1996, at 486-487 (in Chinese).

¹¹³ See Zhou Zhengqing (ed.), *Reading materials on Securities*, Financial Publishing House of China, 1998, at 1 (in Chinese).

adoption of the Securities Law after debate for six and a half years proves that the primary political hurdle against the securities market has been passed.

The Law in several aspects closes the gap between the practice in China and other market economies. The emphases on transparent procedures, professional involvement and standards and centralized regulatory regime are examples in this regard. Moreover, the Law well focuses on risk prevention and investors' protection with tightened standards and penalties. Further, as compared with the previous rules, the legislation is more based on market efficiency and the conditions in China. The changes in acquisition rules and emphasis on development of company bonds¹¹⁴ illustrate such efforts.

However, it also should be noted that the passage of the Law is not made on a basis of successful solutions of all the sensitive political and commercial issues, but rather a result of internal and external pressures, including serious corruption, extensive market violation and the Asia financial turmoil.¹¹⁵ As such, quite a few very important issues are either unsatisfactorily dealt with, or intentionally avoided.

According to Professor Li Yining, the unripe conditions have made the Law to fail to address eight important questions: the restriction on transfer of state and legal person shares; opening over-the-counter market for trading unlisted shares; certain irregular internal issuing of securities to employees; right issuing; the separation of A and B share markets; the price distortion among A, B and foreign listed shares of the same company; listing China-funded companies in Hong Kong; and the appointment of the general managers of exchanges directly by the government.¹¹⁶

In addition to the continuation of the strong government control over the securities market which has disappointed many, the Law also fails to provide definitions of many key concepts and to set out acquisition rules governing transactions between affiliates. As such, the Law surely needs many detailed supplements in a timely manner. As Professor Anthony Leoh, the former Chairman of the Hong Kong Securities and Futures Commission points out, the Chinese market is very unsophisticated, and so are its regulators.¹¹⁷ After the adoption of the Law, Mr. Zhuo Zhengqing, the Chairman of the CSRC has promised that the year of 1999 would be devoted to an overhaul of all the existing securities regulations.¹¹⁸ Despite the defects, it must be recognized that the Law has laid down a solid step-stone for further development of the securities market in China and will have deep impacts in the regulatory regime.

¹¹⁴ According to the World Bank, corporate bonds have been the least developed part of the Chinese securities market. World Bank, *China 2020: Development Challenges in the New Century*, World Bank, 1997, at 35.

¹¹⁵ Matthew Cosans, A Capital Market: Recent Market Turmoil May Help Spur Legal Reform in China's Securities Market, *The Hong Kong Accountant*, issue of November/December 1998, at 53-55. The World Bank has also pointed out that several crucial aspects of the Chinese securities market demanded codified rules. World Bank, *ibid*, at 34-35.

¹¹⁶ China Xinhua News Agency, Issues Raised from the Examination of the Draft Securities Law, 6 November 1998, available at <http://www.chinainfobank.com> (in Chinese).

¹¹⁷ Securities Law: A Good Beginning, March (1999) *China Economic Review*, at 19.

¹¹⁸ China Xinhua News Agency, The CSRC Chairman Zhuo Zhengqing on the Securities Law, 30 November, 1998, *ibid*.

**Ongoing Challenges for Setting and
Establishing International Banking Standards**

Mr. George Pickering

Ongoing Challenges for Setting and Establishing International Banking Standards

**Presentation to the
Conference on the New International Financial Architecture
4th June 1999, Hong Kong**

**by
George Pickering
Chief Representative
BIS Asian Office**

In my remarks today I will address the ongoing challenges to improving international banking standards. I will start with a brief review of the recent economic and financial developments in Asia that provide the background to further improvements in banking standards. I will then summarize the key characteristics of the new BIS capital accord which was announced this week. Thirdly, I will discuss the efforts underway at the international level to promote improved global banking standards. Finally, I would like to give some personal comments on the role of the legal profession in promoting best practice in the banking area.

My message is that improvements in banking standards needs to be carried forward to permit sustained recovery and that this will require continued improvements in banking regulation and supervision.

(I) The background to banking reform

1. Linkages between macroeconomic and financial stability

A lack of financial stability can contribute to macroeconomic instability. The experience of many Asian countries in the last two years showed that generally prudent fiscal policies and respectable inflation outcomes could be ultimately undone by financial vulnerabilities. The implication for Asia is that policy initiatives now have to be undertaken on both fronts, macroeconomic and financial stability, if a recovery in economic activity and living standards is to be sustained.

In recent months equity prices and foreign exchange rates in the region have generally strengthened, despite giving up part of these gains in the last few weeks. Signs of economic recovery in the region are broadening (with some exceptions) and most economies are now

showing that the worst may be behind them. I will leave to others to answer the question of whether the financial markets are too far ahead of the real economy. Suffice it to say that the markets seem to be pricing in a great deal of financial sector reform for which policy-makers are still striving. Moreover, prior excessive lending and the sharp economic downturn in the last two years has left East Asia with a debt overhang which is much worse than those suffered in advanced countries in recent years.

Is this financial sector problem important or will restored confidence in Asia, as reflected by the rally in equity markets and firmer exchange rates, result in the return of the Asian boom? In my opinion there is a risk that the overhang of non-performing loans today will continue to cripple most banking systems in Asia. Furthermore, even if banks with high levels of bad loans remain open, their management will remain preoccupied with managing bad debt instead of making new loans. For example, bank credit is not growing or barely growing in Malaysia, the Philippines and Thailand; renewed bank lending is key to a sustained economic recovery.

2. Strengthening prudential regulations and supervision

In the years preceding the recent Asian crisis, the global trends towards progressive relaxation of credit controls and reserve requirements, coupled with reduced capital controls and increased competition encouraged banks to compete aggressively for new business. This resulted in banks moving into riskier and less profitability activities. These trends created a need for greater rather than less supervision, but this was generally not the case. More recently, since most of the recent instability in the region has been linked to weaknesses in its financial systems, the focus of efforts is now being directed towards making these systems stronger. In most Asian economies, there is an active review process underway and major steps are being taken to improve **regulation and supervision**.

(II) BIS Capital Accord

1. Problems with the existing Accord

The Basel Capital Accord was promulgated in 1988 by the Basel Committee on Banking Supervision, a Committee of G-10 bank supervisors whose meetings are sponsored by the Bank for International Settlements in Basel. The Accord is justifiably regarded as a regulatory landmark and has had a profound influence on banking institutions around the

world. It is probably true to say that no member of the Basel Committee in 1988 had an accurate conception of how influential the Accord would turn out to be. It has had a deep-seated effect on bank behaviour, initially in the G10 and OECD countries, but more recently in many other countries. The agreement changed the character of the Basel Committee itself too. Although other agreements had been reached before 1988, they concerned the activities of bank supervisors and not directly those of banks. It is rare now for a day to pass without any mention of the Basel Committee in the press.

The world financial system has witnessed considerable economic turbulence over the last two years and the risks that internationally active banks have had to deal with have become more complex and challenging. Over the last decade there have been significant improvements in risk management in banks and there is a wide spread view that the Accord needs to be revised in order to ensure that the regulatory capital requirements reflect underlying risks. For example, there has been considerable evolution in asset securitisation structures and as a result the current Accord has been less effective in ensuring that capital requirements match a bank's true risk profile. Another related and increasing problem with the existing Accord is the ability of banks to arbitrage their regulatory capital requirement and exploit divergences between true economic risk and risk measured under the Accord. Regulatory capital arbitrage can occur in several ways, for example, through some forms of securitisation, and can lead to a shift in banks' portfolio concentrations to lower quality assets. Finally, for some types of transactions, the Accord does not provide the proper incentives for risk mitigation techniques. For example, there is only minimal capital relief for collateral, and in some cases, the Accord's structure discourages the use of credit risk mitigation techniques.

2. New Accord

Yesterday, the Basel Committee released a consultative paper on a new capital adequacy framework to replace the 1988 Accord. There are three key pillars to the revised capital framework. The first pillar of the framework is the **minimum regulatory capital requirements**, building on the strengths of the existing Accord. The second pillar is the **supervisory review** of an institution's capital adequacy and internal assessment process. The third pillar, which the Committee has underlined in recent years, is the need for greater **market discipline**.

a) Minimum capital

When the Accord was first established, it was primarily concerned with minimum capital standards to cover credit risk. Given that capital charges needed to cover other types of risk, these were effectively assumed to be proportional to credit risk. In recent years, there was an amendment to the Accord to include a specific charge for the market risk arising from the trading books of internationally active banks. It is now proposed that an explicit capital charge be made for other risks such as operational risk and interest rate risk in the banking book for banks where interest rate risks are significantly above average. Such a framework would formally take account of a wider range of actual and potential exposures.

With regard to **minimum regulatory capital requirements**, building on the foundation of the current Accord, there will be a "standardised" approach for capital requirements at the majority of banks. However, there are several proposals to clarify and broaden the scope of application of the current Accord. With regard to risk weights to be applied to exposures to sovereigns, the existing approach will be replaced by a system that would use external credit assessments for determining risk weights. It is intended that such an approach will also apply, either directly or indirectly and to varying degrees, to the risk weighting of exposures to banks, securities firms and corporates. The result will be to reduce risk weights for high quality corporate credits, and to introduce a higher-than-100% risk weight for certain low quality exposures. A new risk weighting scheme to address asset securitisation, and the application of a 20% credit conversion factor for certain types of short-term commitments are also proposed.

For some sophisticated banks, it is believed that an internal ratings-based approach could form the basis for setting capital charges, subject to supervisory approval and adherence to quantitative and qualitative guidelines. The Basel Committee will (in consultation with the industry) be examining these issues, and will seek to develop an alternative approach based on internal ratings within the same timeframe as its review of the "standardised" approach. Looking further ahead, developments in portfolio credit risk will be modelled for its possible use in regulatory capital calculations.

The capital treatment of a number of important credit risk mitigation techniques is also under review. To assist in this process, the comments are being sought on approaches for

devising a sound and consistent approach for credit derivatives, collateral, guarantees, and on-balance-sheet netting.

I would like to focus briefly on the possible use of external credit rating agencies since this proposal will result in an expanded role for these agencies and will provoke discussion given questions about their role in Asia over the last few years. The new proposal is very general on how these agencies will be allowed to serve as the basis for regulatory capital requirements. National supervisors will have to be satisfied that such an institution meets minimum standards, including transparency, objectivity, independence, credibility and the possession of a track record.

There has been a growing realization of the significance of **operational risk**, which has been at the heart of several banking problems in recent years. The Basel Committee is proposing to develop capital charges for such other risks. Among the proposals under consideration are: basing a capital charge on a measure of business activities such as revenues, costs, total assets, or, at a later stage, and internal measurement systems. Another possible proposal is to create differentiated charges for businesses with high operational risk based on measures commonly used to value those business lines. Particular regard will need to be paid to the capital arbitrage potential, to any disincentives to better risk control that might thereby be created and to the capital impact for particular types of banks. Qualitative factors such as the integrity of the controls process and internal measures of operational risk should be considered. As with many of the proposed changes, the Committee is looking forward to creating a dialogue with the industry on possible specifications.

The significance of interest rate risk within some banking books (depending on a bank's risk profile and market conditions) is also being examined. This is being envisaged for banks where interest rate risks are significantly above average. It is recognised that some national discretion would be necessary regarding the definition of outliers and the methodology of calculating interest rate risk in the banking book.

b) Supervisory review

The second pillar of the capital adequacy framework, the **supervisory review of capital adequacy**, will seek to ensure that a bank's capital position is consistent with its overall risk profile and strategy and, as such, will encourage early supervisory intervention. Supervisors should have the ability to require banks to hold capital in excess of minimum

regulatory capital ratios. Supervisors already review and evaluate a bank's capital adequacy through on-site examinations, off-site surveillance, and review of the work of internal and external auditors. Supervisors are also expected to review the internal capital adequacy assessments of banks and to discuss the internal capital targets set by each. In evaluating a bank's overall capital adequacy, supervisors will have to consider various factors, including the bank's risk appetite and its track record in managing risk; the nature of the markets in which the bank operates; the quality, reliability and volatility of its earnings; its adherence to sound valuation and accounting standards; the diversification of its activities; and its relative importance for the national and international financial markets.

Of course, such a supervisory programme has serious resource implications for most bank supervisors and consideration may need to be given to the number and skill level of supervisory staff required to carry out this work. Further, this requires bank supervisors to work in close co-operation to evaluate the risk profile of internationally active banks and to ensure consistency of standards across national borders.

c) Market discipline

The third pillar, **market discipline**, will encourage high disclosure standards and enhance the role of market participants in encouraging banks to hold adequate capital. The Committee proposes to issue later this year guidance on public disclosure that will strengthen the capital framework. A recent paper by the Basel Committee discusses how a bank that is perceived as safe and well-managed in the marketplace is likely to obtain more favourable terms and conditions in its relations with investors, creditors, depositors and other counterparties than a bank that is perceived as more risky. Bank counterparties will require higher risk premiums, additional collateral and other safety measures in transactions and contractual relations with a bank that presents more risk. These market pressures will encourage a bank to allocate its funds efficiently and will help contain system-wide risks.

Differences in banks' reliance on financial markets and in their capital structure mean that the potential for market discipline varies both within and across countries. While an effective supervisory framework and adequate public disclosure are essential, it is not within the authority of bank supervisors to ensure that all incentives for market discipline are in place. For example, a bank may not be subject to market discipline from a fully insured depositor who has nothing at risk, and therefore has no motive to impose discipline. No

internationally active bank could, however, expect to insulate itself entirely from the judgements of markets and the general public.

Effective market discipline requires reliable and timely information that enables counterparties to make well-founded risk assessments. Banks should publicly, and in a timely fashion, disclose all key features of the capital held as a cushion against losses, and the risk exposures that may give rise to such losses. This will enable market participants to assess the bank's ability to remain solvent. This information should, at a minimum, be provided in annual financial reports and should include quantitative and qualitative details on the bank's financial condition and performance, business activities, risk profile, and risk management activities. Looking to the future, the Accord must be responsive to financial innovation and developments in risk management practices and more accurately the risks to which banks are exposed. The Committee therefore will examine further ways of making the capital adequacy framework more risk sensitive and welcomes comments on how best to do this.

d) Scope of application

One of the areas where the new Accord would envisage an expansion of its coverage is to include banking groups. At the same time, it would continue to address the safety and soundness of individual banks within the group. To these ends, it is proposed that the Accord be extended to include, on a fully consolidated basis, holding companies that are parents of banking groups. Banking groups are groups that engage predominantly in banking activities and, in some countries, a banking group may be registered as a bank. In addition, the Committee is clarifying the Accord's application on a fully consolidated basis to all internationally active banks at every tier within a banking group. Further, supervisors should ensure that each of the banks within a group is adequately capitalised individually.

Banks have increasingly expanded into other areas of financial activity, especially the securities and insurance industries. The Committee is therefore clarifying capital treatments for banks' investments in those areas. The Committee is also clarifying the capital treatment for significant minority-owned entities and is seeking industry views on the appropriate capital treatment for majority-owned investments in commercial entities. With regard to diversified financial groups, the Committee recognises the need to continue working with insurance and securities supervisors to align capital adequacy standards, and supports the

application of techniques such as those developed by the Joint Forum on Financial Conglomerates.

With respect to the definition of regulatory capital, the Committee will maintain at this stage the existing rules as set out in the 1988 Accord (and clarified in the press release of October 1998 on the definition of Tier 1 capital). With respect to both regulatory capital and measures of risk exposure, the Committee stresses the importance of sound accounting and valuation principles that produce realistic and prudent measures of assets and liabilities and related profits and losses in the determination of capital reserves. Weak or inadequate accounting policies undermine the usefulness of capital requirements by causing overstated or unreliable capital ratios.

e) Next steps

This paper is being released for consultation. Comments should be submitted not later than 31 March 2000 to relevant national supervisory authorities and central banks.

(III) Core Principles Methodology

The Core Principles for Effective Banking Supervision, developed by the Basel Committee on Banking Supervision in cooperation with supervisors from non-G-10 countries, was announced in September 1997. This document contains twenty-five basic Principles which need to be in place for a supervisory system to be effective. Since its release it has become the benchmark against which the international financial community assesses the effectiveness of bank supervisory regimes. The vast majority of countries have endorsed the Core Principles and have declared their intention to implement them.

This year the focus of attention has shifted from acceptance of the core principles towards their actual implementation. Experience has already shown that the Core Principles may be interpreted in widely diverging ways, and incorrect interpretations may result in inconsistencies among assessments. With this in mind, last Autumn the Basel Committee began to prepare a document for use in compliance assessments. The drafting was done by an ad hoc working group consisting of representatives from Basel Committee member institutions and the IMF and World Bank. As a first step to full implementation, there should be an assessment of the current situation of a country's compliance with the Principles. Such an assessment should identify weaknesses in the existing system of supervision and

regulation, and form a basis for remedial measures by government authorities and the bank supervisors. Such assessments are typically conducted by the countries themselves or by various outside parties.

The Basel Committee has decided not to make assessments of its own due to a lack of necessary resources; however, it is prepared to assist in other ways, *inter alia* by providing advice and training. Basel Committee members may also individually participate in assessment missions conducted by other parties such as the IMF, the World Bank, regional development banks, regional supervisory organisations and private consultants. In the context of its surveillance mandate, the IMF will encourage its member countries to comply with the Core Principles, and will work with them in assessing compliance on a case-by-case and priority basis. In the course of its regular operations, the World Bank will encourage its client countries to adopt the Core Principles and will also work with them to assess their supervisory framework against the Principles. Both the IMF and the World Bank will seek to have countries remedy identified weaknesses in their regulatory and supervisory regimes, and will provide technical assistance and training to address such weaknesses on a priority basis. To meet the increasing demands in the financial sector area, both institutions are increasing the number of staff with financial sector expertise. These organisations will also utilise resources made available by supervisors world-wide as a means to help countries that ask for technical assistance with the intention of assessing their supervisory systems against the Core Principles. "Peer reviews" are also possible, whereby supervisory experts from one country assess another country and vice versa.

In order for this process to be meaningful, assessors will need to have access to relevant information, without violating legal requirements for supervisors to hold certain information confidential, and to a wide range of organisations and experts. The assessment must consider a chain of related requirements, which may encompass laws, prudential regulation, supervisory guidelines, on-site examinations and off-site analysis, supervisory reporting and public disclosures, and evidence of enforcement or non-enforcement. It also emphasises the importance of the supervisory agency having the necessary skills, resources and commitment to implement the Core Principles.

To achieve full compliance with a Principle, the essential criteria generally must be met without any significant deficiencies. There may be instances, of course, where a country can demonstrate that the Principle has been achieved through different means. Conversely,

due to the specific conditions in individual countries, the essential criteria may not always be sufficient to achieve the objective of the Principle, and therefore the additional criteria and/or other measures may also be needed in order for the aspect of banking supervision addressed by the Principle to be considered effective.

Financial reforms and better banking supervision require broad-ranging and intensive efforts over a long period of time. However, it is of the utmost importance that national supervisory authorities take immediate steps to: i) identify weaknesses in their supervisory system; ii) address the most urgent weaknesses; and iii) urge public authorities to support fully all necessary measures to strengthen financial sector stability, including the implementation of the Core Principles.

There is a need for a harmonised assessment methodology. The Core Principles were designed to provide general guidance that could apply to various supervisory regimes, allowing some flexibility in the design and implementation of concrete measures. In so doing, the Basel Committee was also aware that national supervisory authorities might misinterpret the Core Principles. In the same vein, the assessment of compliance with the Core Principles by numerous interested parties (e.g., the IMF, World Bank, regional supervisory groups, regional development banks, consulting firms) is likely to result in varied interpretations and possibly inconsistent advice. The results of the major assessments may not be made public. In order to achieve full objectivity, compliance against the Core Principles is best assessed by a suitably qualified outside party consisting of at least two individuals with varied perspectives so as to provide checks and balances. The supervisory agency and its staff have credibility based on their professionalism and integrity.

There is a general recognition that effective banking supervision requires a set of preconditions to be in place. Perhaps the most important aspect is the existence of a proper credit culture, i.e., an environment that fosters the honouring and enforcement of financial contracts. An adequate infrastructure also requires that accounting standards approach international best practices, so investors and supervisors can properly evaluate the financial condition of the banks, and the banks can monitor the health of the institutions to which they lend. Accurate financial data requires a professional body of accountants and auditors. Other key considerations in evaluating the public infrastructure are the effectiveness of supervision in other financial sectors and markets, as well as the risks inherent in the payment system.

(IV) Legal Issues related to improving banking standards

Let me turn briefly to the link between the processes which I have been discussing above and the topic that might best address the interests of the legal profession and of your meeting today. The reduction of banking risk requires the continued reduction in legal risk. Banks and the general public would benefit from a clear description of the legal characteristics of both the new instruments and any new institutional structures being put in place. The corporate and credit culture which sustains a stable financial system must be built, inter alia, on contracts governing bankruptcy, collateral and loan recovery. This must cover the full range of financial issues, including laws identifying the responsibilities of the board of directors with respect to corporate governance, in order to ensure that there is effective control over every aspect of risk.

A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place. Clear laws need to be in place for banking, and for (each of) the agency (agencies) involved in banking supervision. The responsibilities and objectives of each of the agencies are clearly defined.

The laws and/or supporting regulations need to provide a framework of minimum prudential standards that banks must meet. The supervisor needs to clearly participate in the definition of a structure which defines when and how to effect the orderly resolution of a problem bank situation (which could include closure, or assisting in restructuring, or merger with a stronger institution). Banking laws need to be updated as necessary to ensure that they remain effective and relevant to changing industry and regulatory practices.

(V) Conclusion

The financial situation in Asia has stabilized remarkably in the last half year. This provides an environment to promote banking sector restructuring. In my view this reform is essential to rekindling sound economic growth of a durable nature. This reform effort needs to be ambitious, wide-ranging, and realistic. It also needs to be supported by continued improvements in prudential regulations and supervision of the financial sector. Even if this

restructuring and reform is speedily introduced the process will be a long one. Nonetheless with proper support and initiative there is a good prospect of preventing the financial system from exerting a chronic drag on growth in the region. A precondition for financial stability is the continued improvement in the legal underpinnings of financial contracts, and laws supporting good corporate governance and supervision. The legal profession has the key role to play in this area.

**The New Financial Architecture and Its
Implications for Hong Kong**

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The New Financial Architecture and Its Implications for Hong Kong

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Synopsis

This paper is divided into four sections. The first section briefly introduces the concept of "New Financial Architecture" (NFA) and its origin. The second section deals with the background and analysis of NFA. By providing a taxonomy of financial crises during the past three decades, the urgency and significance of NFA can be better understood and appreciated. This is followed by an analysis of what should be the key pillars of the NFA if it is to be a credible and effective edifice of international finance. Section III is devoted to the implications of NFA for Hong Kong. Since this cannot be properly understood without knowing what Hong Kong has endured, an analysis of the effect of the Asian Financial Crisis (AFC) on Hong Kong is first presented. Section IV ends the paper with concluding remarks.

Hong Kong, as a victim but not an originator of the AFC, and one of the few havens of stability in Asia, has always strongly supported the NFA ever since it was publicly proposed. The territory is too small, however, to exert any real influence over the establishment of the NFA. The heart of the matter is that the agenda for international financial reform is virtually dictated by a small group of rich industrialized countries, whose interests do not coincide with that of the vast majority of developing countries or emerging economies. Thus, the reform of international finance will lack credibility if the current practice of G-7 dominance is not itself reformed.

THE NEW FINANCIAL ARCHITECTURE AND ITS IMPLICATIONS FOR HONG KONG

Y. C. Jao

"Nichts sagt so deutlich, aus welchem Holz ein Volk geschnitzt ist,
wie das, was es währungspolitisch tut." ¹

Joseph A. Schumpeter (1883-1950)

I. Introduction

The concept of "New International Financial Architecture", or more concisely, "New Financial Architecture" (NFA), was first endorsed, at the official level, at the 53rd joint annual meetings of the International Monetary Fund (IMF) and World Bank held on October 6-8, 1988 in Washington, and attended by finance ministers and central bank governors representing IMF's 182 member countries. Earlier, in the April 1988 meeting, also in Washington, of finance ministers and central bank governors from 22 economies (G-22), preliminary discussions had already been made on issues relating to the strengthening of the international financial structure.²

While the terminology of NFA is new, its contents are not. At least since the breakdown of the Bretton Woods system (BWS) in the early 1970s, eminent economists have been discussing and proposing ways and means of establishing a new international financial system, or improving the existing one, under various ponderous titles. But NFA is undoubtedly a much more catchy term, and is frequently bandied about to show that the speaker is *au courant* with high finance.

In actual fact, NFA is still a nebulous concept, the precise meaning of which is often unclear to the user. Even the IMF's explanations of the key features of NFA can be questioned for being vague and incomplete (see below). In any case, NFA is only a proposal, not an established fact.

The purpose of this paper is to provide a fuller analysis of NFA, with special reference to its implications for Hong Kong. The paper is organized as follows. Proceeding from the present introduction, the next section begins with an overview of the historical background to the NFA, and continues with an analysis of what should be the key pillars of the NFA if it is to be a credible and effective edifice of international finance. Section III is devoted to the implications of NFA for Hong Kong. Since this cannot be properly understood without knowing what Hong Kong has gone through during the past two years, an analysis of the impact of the Asian Financial Crisis (AFC) will first be presented. The fourth section ends the paper with concluding remarks.

II. New Financial Architecture: Background and Analysis

(a) Background

Since the breakdown of the Bretton Woods System (BWS) in the early seventies, the international financial landscape has continued to be dotted by recurrent crises of one kind or another.³ To recount such crises chronologically would be both time-consuming and boring. I propose therefore to classify the post-1973 crises according to their nature and origins, while recognizing that the collapse of the BWS itself was an international catastrophe of the first order. The principal categories are as follows.

1. Crises involving currencies of major industrial powers.

Essentially, there were crises involving the US dollar, pound sterling, and the Japanese yen, during different periods of time. Of these three, however, only the US dollar plays the dominant role as an international trading and reserve currency

2. Crises of balance of payments

These involved mainly oil-importing countries after the two oil shocks in the 1970s. Both developed and developing countries were affected. Only oil-producing or oil-exporting countries benefited financially during these crises.

3. Third World Debt Crisis

Following the default of Mexico in 1982, a large number of developing countries in Latin America, Asia, Africa, and Eastern Europe also declared their inability to repay their foreign debt. This crisis, though now overshadowed by the AFC, has still not been fully resolved.

4. Equity market crash

The most spectacular mishap under this heading was, of course, the 1987 world-wide stock market crash led by Wall Street. Mercifully, the threatened global meltdown was short-lived, as the US Federal Reserve immediately injected substantial liquidity into the financial system. However, in the current AFC, national equity markets had, at different points of time during the past two years, fallen by up to 70%.

5. Crises involving exchange rates in a regional currency bloc

The principal example was the European Exchange Rate Mechanism (ERM) crisis of 1992-93, during which Britain and Italy were forced to withdraw from the bloc.

6. Mixture of currency and debt crises

Major examples were Mexico in 1994-95, Russia in August 1998, and Brazil in January 1999.

7. Mixture of currency, banking, and debt crises

The outstanding example here is the AFC, which is still on-going. The gravity of this crisis exceeds all others in terms of scope, intensity and duration.

It is to be noted that the above classification, while convenient conceptually, does not imply that the various categories are mutually exclusive. In fact, some of them overlap each other to some extent. But whatever their characteristics, one thing is certain: the cumulative result of such recurrent crises has been a colossal human tragedy in terms of lost output, income, employment and wealth. The current Asian crisis, the worst of its kind since the end of World War II, is especially unexpected and baffling, since it is not fully explicable by fundamentals. Many economists are now of the opinion that the punishment which Asia has suffered is way out of line with its perceived institutional and structural shortcomings and weaknesses.

The AFC, together with the recent new crises in Russia and Brazil, should be sufficient to demonstrate that the need for a NFA now is just as pressing as that facing the war-time allies when they met some 55 years ago at Bretton Woods to map out a plan for the postwar reconstruction of a world financial order.

(b) Analysis

Having outlined the background to and the need for a NFA, we are now in a position to analyze

in greater detail the concept's contents and implications. According to Michel Camdessus, Managing Director of the IMF, the NFA must rest on the following five underlying principles (International Monetary Fund, 1998, p. 310):

"Transparency. This is the golden rule. Ultimately, the effectiveness of this reform will hinge on how ready members and market participants are to adopt the standards for transparency and how well the IMF uses them in surveillance.

Strengthened Banking and Financial Systems. Strong frameworks for regulation and supervision must be put in place, supported by the worldwide adoption of consistent standards for accounting, auditing, insurance, securities, payments systems, and banking supervision. The IMF is strengthening its capability in this area by refocusing its bilateral and multilateral surveillance as well as its technical assistance and training. Together with the World Bank and other agencies, we must move forward rapidly in the context of a framework for financial stability.

Involvement of the Private Sector. Two objectives come to mind: first, establish the proper incentives to foster sustained private sector participation in global capital markets, minimizing the risk of sudden withdrawals; and, second, in realizing it, avoid moral hazard. We must work more on these issues.

Liberalization. The aim should be to progress cautiously and in an orderly fashion on our path toward a liberal system of capital movements set in the context of properly sequenced financial reform and of strong macroeconomic balances.

Modernizing the International Markets. To establish for all international financial operations the practices and discipline prevailing in the best working financial centers, we need consistent world standards in the monetary and financial areas of core concern to the IMF and in accounting, auditing, bankruptcy, and corporate governance, which are the concern of other agencies."

As the IMF is one of the key pillars of the international financial order since 1945, the five principles enunciated above can be regarded as an authoritative statement deserving the closest attention. Each of the five principles, taken by itself, is unexceptionable, and should indeed be accepted as the basis on which the NFA should be erected. However, taken together, the five principles still fall short of ensuring a credible and viable international financial system in the sense that financial markets can function normally, and capital movements can take place in an orderly manner, without frequent and contagious speculative attacks and currency crises, which as the AFC has demonstrated, can cause untold damage to the financial sectors and real economies of the countries/territories affected.

The IMF statement is silent for example on several important matters that require urgent attention. The first is the all-important question of exchange rate stability. Since the breakdown of BWS, the world has been characterized by a hodge-podge of exchange rate regimes. Thus, the currencies of three of the largest economies, namely, US, Japan, and China, are on a managed floating basis; the European Union is moving towards a single currency with the launching of the euro in January 1999, though Great Britain and some other European countries are still undecided whether to throw in their lot; smaller countries/territories peg their currencies to one or more key currencies either through the Currency Board Arrangement (CBA), or through regional blocs. There is little or no attempt to harmonize these disparate regimes, or at least to stabilize the exchange rates of key currencies through a formal international framework or mechanism.

One proposal which has regained favour recently, in the light of the AFC, is the "target zone". Contrary to its critics, this idea is not something concocted by headline-hunting politicians, but is a serious proposal for international financial stability that has an impeccable academic pedigree. Originally known as the "band" proposal, it was aired in the late sixties, just before the breakdown of the BWS (see Williamson, 1992, for an excellent survey).

The basic idea of a "target zone" is that exchange rates fluctuations should be held within a range of reasonable estimates of the medium-term parities under a flexible exchange rate regime, either by interventions by national authorities separately, or better still, by joint cooperative interventions by key currency countries, should the actual fluctuations go outside the upper and lower limits of the zone. Early advocates of the band already correctly foresaw, contrary to the simplistic optimism of Friedman (1953) and Johnson (1972), that unrestrained floating could result in exchange rate "over-shooting" quite out of line with economic fundamentals. Recent empirical studies (e.g., Woo, 1985 and Rose, 1994) have confirmed that excessive volatility in exchange rates can have serious real consequences. And of course, the current AFC provides additional incontrovertible evidence.

As to the argument that exchange rate targeting will not be effective, Krugman in his influential works (1988, 1989) has shown that this is not true if the authorities' commitments are credible, and the permitted band is sufficiently wide. Subsequent events have tended to support this reasoning. Thus, after the European Union decided in July 1993 to widen the band of the ERM to $\pm 15\%$ of the parities, speculation soon subsided. Similarly, the joint interventions by US and Japan in June 1988 also succeeded in arresting what seemed at that time to be a free fall of the yen.

Unfortunately, tentative approaches by the European Union and Japan for setting "target zones" for the three key currencies, US dollar, euro and yen, have been brusquely ruled out of court by the US. The official US position, as announced by Treasury Secretary Robert Rubin, is that sound economic policies, and not efforts to set up target zones, are the key to stabilizing jittery foreign exchange markets.⁴ This position is surely disingenuous, for in the past, the US had not hesitated to organize joint interventions, such as the Plaza Agreement of 1985 and the Louvre Accord of 1987, if they suited its own purposes.⁵ Moreover, the US completely ignores the AFC evidence that the large exchange rate realignments were not justified by economic fundamentals on the eve of the crisis, but which have wreaked havoc on economies throughout the region.

While the current stance of the US is unhelpful, advocates of the "target zones" need not despair, but should instead intensify their efforts to persuade the three major powers to shoulder greater responsibilities to ensure exchange rate stability, not in the sense of rigidly fixed rates, but in the sense that exchange rate variations should be orderly and should not trigger unwarranted panics. It is inconceivable that a NFA can be meaningful without exchange rate stability in the above sense.

The IMF statement cited above also is silent on other measures which may be adopted by member states to strengthen the NFA. One is capital controls, which may either be taken to curb unwanted "hot money", or adopted as longer-term transitional arrangements pending the establishment of a robust modern banking system and a sound prudential framework. Such controls were in fact quite prevalent not only among developing countries, but also highly developed countries such as Japan, Britain, and EEC countries before the full-scale liberalization from about 1979 onwards. One lesson from the AFC is that financial liberalization should occur in an orderly and sequential manner so as to avoid the sudden and disruptive inflow and outflow of capital which can often be catastrophic. Malaysia, for example, re-imposed capital controls in September 1998, but this came too late to shield it from the impact of the AFC. However, an interim committee set up by the IMF in the October 1998 did recognize that, under certain circumstances, the use of capital controls might be appropriate.

Another possible measure to curb excessive capital movements and exchange rate volatility is the "Tobin Tax", named after the Nobel Laureate, James Tobin, who advocated a tax on forex transactions in order to "throw some sand in the wheels of international finance" (Tobin, 1978). The proposal was at first dismissed as unworkable and irrelevant by mainstream economists, but recent events have rekindled interest in the idea. (see "Policy Forum: Sand in the Wheels of International Finance", *Economic Journal*, Jan. 1995).

If the "Tobin tax" is imposed by separate national jurisdictions without international cooperation and coordination, the critics are right that forex transactors will emigrate to offshore financial centres, evading the tax completely. This is the familiar phenomenon of "regulatory arbitrage". If, however, the NFA membership is universal and all financial centres agree to a credible scheme of international cooperation and harmonization, then the tax, being universal and uniform, becomes much more feasible. It is true that the tax may fall on non-speculators as well, but if the tax is structured for short-term holding periods, then it is mainly the speculators, who typically have shorter horizons, who will be affected. As Eichengreen, Tobin and Wyplosz (1995) have pointed out, "those inclined to dismiss such proposals as unrealistic deserve to be reminded that another multi-national organisation, the GATT, has succeeded rather well at enforcing much more complex rules of international economic conduct. Moreover, there is good reason to think that the future of the BIS and the IMF lie precisely in the realm of international financial surveillance" (p. 166).

For a small country which does not harbour ambitions to be an major international financial centre (IFC) or international business centre (IBC), if it is considered that the costs of losing forex business are more than outweighed by the benefits of exchange rate and financial stability, then the Tobin tax is an attractive policy option even without international coordination. Malaysia is a good example. Its "exit tax" on short-term foreign capital, recently adopted to replace the capital controls imposed last September, is basically a form of "Tobin tax". For countries like Malaysia, therefore, the question boils down to the optimal tradeoff between international integration and national autonomy. The fact that China and Taiwan have fared relatively well during the current AFC is at least partly attributable to their retention of capital controls.

To sum up, then, proposals like target zones, capital controls, and Tobin tax should not be dismissed out of hand, but should be carefully considered, each on its merits, as part of the package of stabilization measures which the NFA may approve for member countries, depending on the actual circumstances.

Even the five principles mentioned earlier, which are unexceptionable in themselves, are somewhat vague and could be further elaborated. For instance, both the IMF and the World Bank have preached regularly about the need for transparency and accountability to their clients. But they themselves have been criticized by economists and other experts during the recent AFC: the former for its poor diagnosis, and for inflicting heavy losses on the economies of its client states through its austerity programmes, and the latter for handing out "soft loans" without regard to such problems as moral hazard, corruption, and other unsavoury aspects of "crony capitalism". (see Kreuger 1998 for a recent assessment). Whether such accusations are justified or is not the issue. The issue is that both IMF and World Bank should apply the high standards of transparency and accountability to their own operations and activities, to explain their policies and programmes in a more open manner, to engage in self-appraisal regularly, to carry out internal reforms, and to manage their resources, contributed as they are by member states, in the most efficient way.

Concerning the principle of strengthening banking and financial systems, it is not often realized that the Bank for International Settlements (BIS) has done a great deal of good work for strengthening banking supervision and surveillance on a global scale but in a low-key manner. Unlike the high-profile IMF and World Bank which have attracted many adverse comments, the BIS has won universal praise and respect for the two important international agreements under its auspices, namely, the Basle Concordat of 1975 and the Basle Accord of 1988.⁶ Its core principles of sound banking, and its guidelines on risk management and financial derivatives etc. are also widely respected and observed, at least in sound jurisdictions. What is needed is a greater cooperation between BIS and the IMF and the World Bank. The three should be the executive arms of any credible and effective NFA.

III. Implications for Hong Kong

As mentioned in the introduction, it is necessary to discuss what Hong Kong has gone through

during the past two years before one can really appreciate the significance of the NFA for Hong Kong.

As an extremely open economy and a major international financial and business centre, Hong Kong cannot avoid being buffeted by the AFC. While it is impossible, within the parameters of this paper, to analyze the origins and causes of the AFC, it would nevertheless be desirable to delineate the proximate causes of this calamitous event. Scholars and experts are still divided on this matter, and an analytic literature is already growing (see *inter alia* Krugman, 1998; Radelet and Sachs, 1998; Moreno, Pasadilla and Remolona, 1998; Kaminsky and Reinhart, 1998; and Miller, 1998). I personally subscribe to what I would like to call the "financial imprudence view". This can be conveniently summarized in Fig. 1, a schema of financial crisis.

According to this view, reckless borrowing by both public sector and private sector entities, matched by equally reckless lending by the banks, without adequate risk management and prudential supervision, will quickly result in illiquidity or even insolvency when a sudden shift in market conditions or sentiments occurs. Runs on depository institutions will be accompanied or followed by runs on the currency. To attract inflow of capital and to protect the exchange rate, high interest rates become inevitable, which cause a sharp downturn in economic activity. This, in turn, aggravates illiquidity or insolvency of firms and banks. This schema applies particularly well to Thailand, Indonesia, and South Korea, and to a lesser extent, to other Asian countries in distress.

The model in Fig. 1, however, does not apply to Hong Kong. The territory has always been renowned for its financial probity. The Hong Kong Government is perhaps unique in having no foreign debt. Indeed, it is sitting on a huge fiscal reserve, accumulated from past fiscal surplus, amounting to HK\$458 billion (US\$59 billion) at 1 April 1998. Even allowing for deficits during the two fiscal years 1998-99 and 1999-2000, the fiscal reserves at 31 March 2001 are still estimated at HK\$383 billion (US\$49 billion), which must be regarded as a *rara avis* in today's world.

The private sector has, of course, foreign liabilities, but they are more than offset by foreign claims. Unlike Thailand, Indonesia, and Korea, whose currencies collapsed because of the inability to repay short-term debt denominated in US dollars, Hong Kong has no such problems. There is, in short, no evidence of reckless external borrowing by either the public or the private sector. This is not to say that Hong Kong has no internal economic problems, notably asset bubble, structural imbalance etc. But unlike Singapore and Taiwan, which have chosen to shift their difficulties abroad, despite their huge foreign reserves, by competitive depreciation, Hong Kong has refrained from this tactic. Instead, it has vigorously defended its currency peg. However, since the Hong Kong dollar is the only convertible currency in Asia which has not depreciated during the current AFC, it has become the favourite target of speculators and manipulators. Moreover, as an extremely open economy and a leading international financial centre (IFC) and international business centre (IBC) in the whole Asia-Pacific region, Hong Kong can hardly avoid the contagious effect of the AFC. The need to raise interest rates to defend the currency, plus the generally depressed condition in the external environment, have inevitably caused severe knock-on effects on the asset markets as well as the real economy. Fig. 2, therefore, represents a much more appropriate model for Hong Kong. The territory, in short, is a victim and not an originator of the AFC.

Hong Kong's refusal to pursue a "beggar-my-neighbour" policy, its willingness to accept sacrifices through painful internal wage-price adjustments, its conscientious observance of its international obligations by granting credits to Thailand and Indonesia under IMF auspices even though it is facing speculative attacks itself – in short, its role as one of the few havens of financial stability in Asia – is not generally appreciated abroad, especially as the Western media and other assorted analysts and commentators have generally taken a highly negative attitude towards Hong Kong, ever since its reversion to China as a Special Administrative Region (SAR).

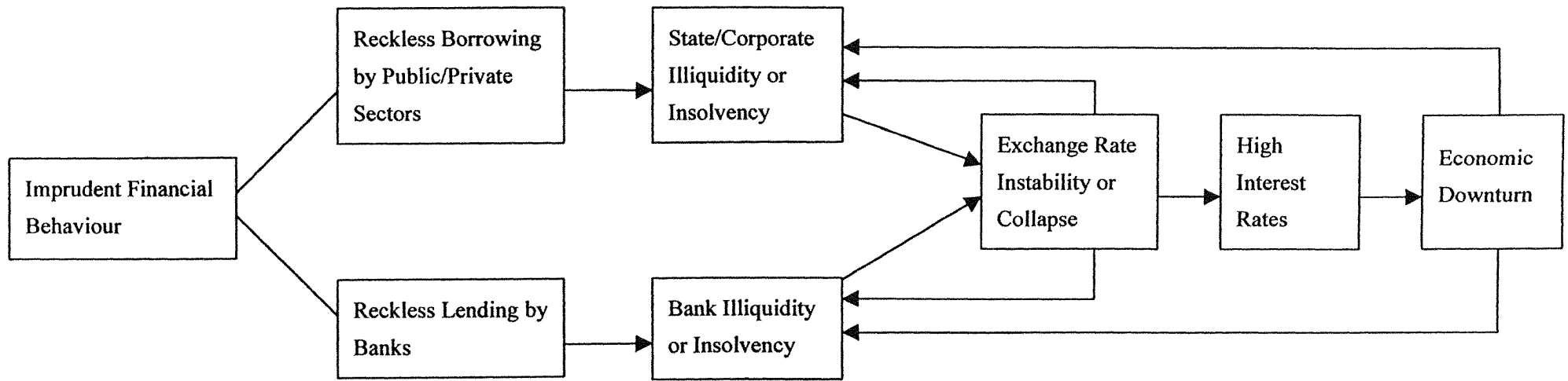


Fig. 1 A Schema of Financial Crisis

To give an example, in the summer of 1998, speculators and other manipulators, led by some hedge funds, which in turn were generously aided by a number of investment banks, launched a ferocious attack on both the Hong Kong dollar and the Hong Kong securities markets, the objective of which was nothing less than the destruction of Hong Kong's financial sector.

By August 13, 1998, speculators had succeeded in driving down the Hang Seng Index of stock prices to 6,660, or 60% off its peak at 16,673 on August 7, 1997.

At this point, the authorities decided to intervene. According to Mr. Joseph Yam, Chief Executive of the Hong Kong Monetary Authority, international speculators were engaged in a massive "double market play" (Yam, 1998). The typical tactic of the speculator-manipulator can be roughly described as follows. He bought US dollars aggressively forward (or sell HK\$ forward, generally for six months). By the covered interest rate parity mechanism, the current interest rate, especially the highly sensitive Hong Kong inter-bank offered rate (HIBOR), must rise sharply. If the forward premium rose further, the speculator could immediately resell at a profit his futures to another party, who may be another speculator, or a hedger or an arbitrageur. At the same time, he sold Hang Seng index futures or sold short equities also aggressively. Because the higher interest rates would hit the cash market index, he could reap a huge profit by such "double market play". During the month of August, international speculators, notably several hedge funds of US origin, made unscrupulous use of unfavourable news such as floods in China, and weakening economies in Japan and Hong Kong and spread all sorts of lies and rumours about the impending devaluation of both the *renminbi* and the Hong Kong dollar. They evidently hoped that the collapse of the stock market would cause a "domino effect", as the banking system and the Hong Kong dollar followed suit. Clearly, such direct assault on Hong Kong's financial integrity must be stopped.

The Government's strategy was to buy heavily in the cash market, in order to force speculators to liquidate their short positions at higher prices.

This counter-attack has however given rise to considerable controversy. While a substantial body of public opinion supported the Government in its bid to safeguard the peg and the financial system, certain sections of the financial community and the media, in particular media abroad, have strongly condemned the government's moves as a significant departure from Hong Kong's traditional "non-interventionist" policy and philosophy, despite the Government's repeated assurances that its intervention was aimed at speculators-manipulators, and not at genuine investors, that its aim was to restore financial order, not to prop up prices at any pre-destined level. The critics' views were in any case rather one-sided, since they typically ignored the vulture-like behaviour of the speculators-manipulators, who have played havoc with so many emerging markets and economies. Criticizing Hong Kong's "interventions" is like criticizing a victim of an act of robbery (or even worse crime) for trying to defend herself.

Anyhow, the Government announced on October 26 the formation of an independent company called Exchange Fund Investment Co. Ltd. and revealed that it had acquired equities at a cost of HK\$118 billion, with an unrealized profit of about HK\$30 billion. The whole portfolio was revealed in detail, and it would be the company's policy to dispose of the portfolio in an orderly fashion. This high degree of transparency in the acquisition of equities is in sharp contrast to other countries (e.g., Singapore).

On September 7, the authorities unveiled a 30-point package designed to tighten regulations of the futures and stock markets, including criminalising unreported short selling, and increasing penalties for illegal short selling from a maximum fine of HK\$10,000 and six months' jail to a HK\$100,000 fine and two years' jail. Another part of the package concerns more coordination between the exchanges and regulatory agencies, and more transparency of the exchanges.

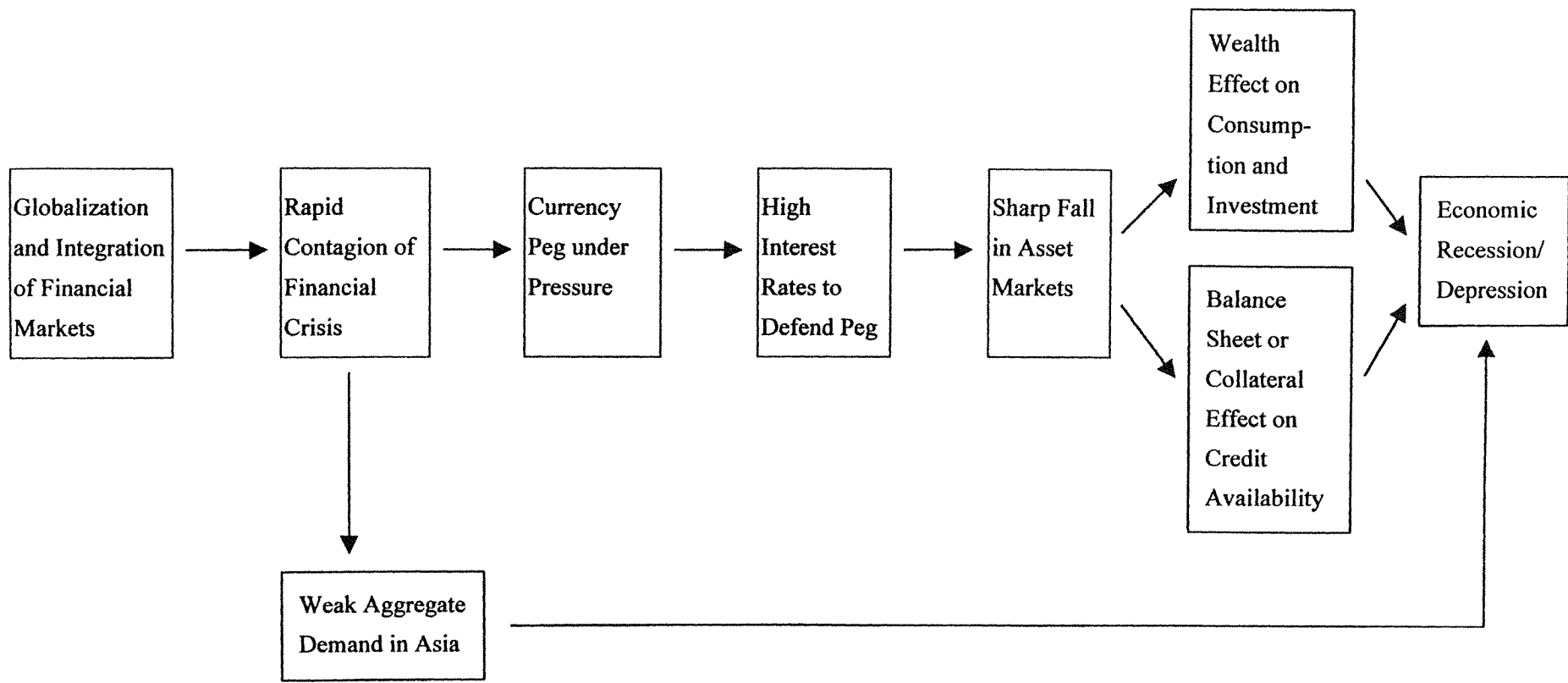


Fig. 2 Effect of Asian Financial Crisis on Hong Kong

Predictably, this package was also attacked by speculators and their friends as well as by vested interests, such as brokerage houses, for violating "free market principles". Again, such self-interested arguments cannot be taken seriously. Short-selling by itself is not illegal, provided it observes the rule that stocks must be borrowed in advance. However, during the recent episode, many "naked short-sellers" did not even bother to abide by this rule, which was glaringly illegal. Another loophole was that the T+2 rule (delivery two days after transaction) was not observed. The Hong Kong Clearing was found to have big speculators the escape route of T+5, frustrating the Government's plan to squeeze them. Fortunately, the Government and Hong Kong Clearing have now reached agreement to strictly enforce T+2.

One fundamental issue which even serious economists have missed is the classic "asymmetric information". The regulatory authorities are expected to be more and more transparent in its policies and operations, and over the past decade they have been doing just that. However, hedge funds and other major players in the futures and stock markets are not under such constraints. The above package is designed to deal with this asymmetry problem.

Although the speculators' repeated attacks on the Hong Kong dollar have been repulsed, the need to raise interest rates has taken its heavy toll on the assets markets and the real economy (Jao, 1998; Tsang, 1998; Jao and Sheng, 1998). Property prices, depending on locations and other attributes, have fallen by 50-60%; while equity prices had fallen by up to 60% at their worst, as mentioned already. The real economy contracted by 5.1% in 1998, the worst performance since Gross Domestic Product (GDP) statistics were first published in 1961. Unemployment had worsened sharply from 2.5% in the last quarter of 1997 to 6% in early 1999, the highest since official unemployment figures were released in 1975. It is reasonable to argue that, had there been no AFC as well as periodic speculative attacks on the currency, Hong Kong would at most have suffered a slowdown, as in 1994-95, but not a catastrophic downturn as in 1998. To repeat, Hong Kong is a victim, not an originator, of the AFC.

For this reason, Hong Kong warmly supported the NFA idea when it was first aired around the end of 1997. Leading officials responsible for Hong Kong's fiscal, monetary, and financial policies, Sir Donald Tsang, the Financial Secretary, and Mr. Joseph Yam, the Chief Executive of Hong Kong Monetary Authority, have repeatedly urged the speedy establishment of a credible and effective NFA, in order to contain the contagion of financial crises, strengthen banking and financial systems on a global scale, and curb the destabilizing activities of highly leveraged speculative vehicles such as the hedge funds.

Hong Kong's stabilizing role in the AFC has received some international recognition at the official level. Hong Kong, being a member of the G-22, was invited to serve as one of the co-chairs of the Willard Group's three working parties, the working party on transparency and accountability. Hong Kong's stance is that maintaining a high degree of transparency and accountability is an important policy objective of the HKSAR Government, which has made great strides in this respect in all areas, including those outside banking and finance. It considers that transparency and accountability can improve economic performance through their disciplinary effects on the decision-making process in both the public and private sectors. While enhanced transparency will not of itself prevent financial crisis, it will facilitate the implementation of corrective actions and lessen the probability of panic and contagion. This working party met in London and Hong Kong in the spring and summer of 1998, and a report was later released in October (Willard Group, 1998). Hong Kong is one of the 46 economies that subscribe to the IMF's Dissemination Standards Bulletin Board (DSBB), which discloses in full the methodologies, assumptions and processes member countries use to generate economic and financial statistics.⁷ In early 1999, following Bundesbank President Hans Tietmeyer's proposal for a Financial Stability Forum, authorized and endorsed by the G-7, Hong Kong was invited to join (International Fund, 1999).

While these gestures are gratifying, it remains true that Hong Kong is too small to exercise any real influence over the establishment of the NFA. In the last analysis, it is the G-7 – US, UK, Japan,

Germany, France, Italy and Canada – that determine the agenda for global financial issues (see Appendix).

The present composition of G-7 is, to say the least, most unsatisfactory. First of all, they are all highly developed industrialized countries. Not one single developing country (or emergent economy, as it is now often called) is represented. Thus G-7 is often seen as a "rich men's club", whose credibility is highly suspect. Second, no less than four of the seven are European countries. Even more ridiculous, the Chairman of the European Commission regularly sits in at its meetings, and in recent years, Russia has also been invited as an observer. Thus, in addition to its inherent economic imbalance, there is also a glaring geographical imbalance. No person with any sense of objectivity can seriously argue, for example, that Canada is more important than China, which even without including Hong Kong, is already the seventh largest economy of the world.

Such imbalance and iniquity have long been recognized by fair-minded and serious commentators on international affairs. I personally do not favour the replacement of Canada by China. I do suggest, however, that the fairest way to reform the G-7 would be to expand it to G-10 by adding three other large economies, namely, China, Brazil and India, which are all emerging economies. This new composition will then largely correct the imbalance and iniquity referred to earlier.

The advantages of the expanded G-10 should be obvious. First, by being more representative, both economically and geographically, it can command much greater credibility and respect throughout the world. Second, with its credibility enhanced, the G-10 can then exercise greater influence on other member states of the IMF, thus making it more likely that the NFA will be successfully launched and widely supported. Third, small countries and territories like Hong Kong can make their voices heard through one or more of the three new members, instead of being completely shut out as at present by the cabal of rich countries.

IV. Concluding Remarks

The concept of NAF has emerged after a series of financial crises in the post-World War II era, culminating in the catastrophic AFC. In many ways NFA can be regarded as overdue. It is not an exaggeration to say that, especially for those countries who have been suffering grievously during the current AFC, the present situation is just as sombre as that confronting the war-time allies, which met in 1944 to re-construct the postwar world financial order.

Hong Kong, as a victim but not an originator of the AFC, and one of the few havens of stability in Asia, has always strongly supported the NFA ever since it was publicly proposed. The territory is too small, however, to exert any real influence over the establishment of the NFA. The heart of the matter is that the agenda for international financial reform is virtually dictated by a small group of rich industrialized countries, whose interests do not coincide with that of the vast majority of developing countries or emerging economies. Thus, the reform of international finance will lack credibility if the current practice of G-7 dominance is not itself reformed.

Appendix

G7 timetable for reform of the international financial system

<p>By Spring 1999 meetings of IMF, World Bank and G7 in April:</p> <ul style="list-style-type: none"> • G7 compliance with IMF good practice code on fiscal transparency • G7 report on strengthening national financial regulation, particularly of highly leveraged institutions • IMF to complete manual for implementing fiscal transparency good practice code and to start monitoring code's implementation • IMF (supported by BIS and others) to complete code of best practice for monetary and financial transparency • IMF to strengthen data dissemination standards • Early findings of BIS committees on disclosure standards for private sector financial institutions and international capital flows • World Bank/IMF interim report on establishing insolvency and debtor-creditor regimes • IMF to report on progress of its policy to lend to countries in arrears to their other creditors • World Bank interim report on development of principles of best practice in social policy • IMF to report on proposals for it and other international financial institutions to publish more information • IMF to report on progress towards formal evaluation mechanism for assessing its 	<p>own effectiveness</p> <p>At G7 Spring meeting: Discuss progress on –</p> <ul style="list-style-type: none"> • Proposals to strengthen World Bank and IMF's Interim and Development Committees • Examining scope for stronger prudential regulation in industrialised countries and emerging markets • Considering necessary elements for maintaining sustainable emerging market exchange rate regimes • Developing new crisis response, including new forms of official finance and ways to include private sector • Strengthening IMF's crisis prevention and response procedure • Policies to protect the most vulnerable in society <p>By OECD Ministerial meeting in May</p> <ul style="list-style-type: none"> • OECD to complete code of principles for sound corporate governance <p>By G7 Cologne summit in June</p> <ul style="list-style-type: none"> • G7 to convene first meeting of Financial Stability Forum • G7 consensus on how to proceed on strengthening national financial regulation, particularly of highly leveraged institutions • G7 consensus on how to promote more collective action clauses in bond issues 	<p>By end June 1999</p> <ul style="list-style-type: none"> • G7 to disseminate information on government and central bank foreign exchange liquidity position <p>By IMF/World Bank Annual Meeting in October</p> <ul style="list-style-type: none"> • IMF and standard-setting bodies to prepare strategy for implementing accounting, corporate governance, data and monetary and fiscal policy transparency standards. Joint paper on this by IMF and World Bank • IMF to finalise structure for transparency reports <p>By end 1999</p> <ul style="list-style-type: none"> • G7 report on private sector compliance with corporate governance and accounting transparency standards <p>By January 2000</p> <ul style="list-style-type: none"> • G7 to comply with strengthened IMF data dissemination standard <p>Others</p> <ul style="list-style-type: none"> • G7 compliance with best practice code on monetary and financial policy transparency, once code is agreed • IMF to continue policies of trade liberalisation, eliminating soft loans by states to favoured industries and non-discriminatory insolvency regimes
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Source : Financial Times, February 27, 1999

Notes

1. This passage is taken from the posthumous book, *Das Wesen des Geldes*, by the renowned Austrian economist, Joseph Schumpeter, and can be freely rendered as : "Nothing shows more clearly the character of a nation than the way in which its monetary affairs are managed."
2. Members of the G-22 were : Argentina, Australia, Brazil, Canada, China, France, Germany, Hong Kong, India, Indonesia, Italy, Japan, Korea, Malaysia, Mexico, Poland, Russia, Singapore, South Africa, Thailand, UK and USA. Four European countries, Belgium, Netherlands, Switzerland, and Sweden joined later to form the G-26.
3. By the "Bretton Woods system", economists mean the system of fixed exchanges which could not be altered except with the approval of the IMF, designed by the war-time allies on the eve of their victory in World War II against Germany and Japan. Despite its shortcomings, the system had ensured, for a quarter of a century, a period of relative financial calm and economic prosperity for the non-communist world. It was undermined progressively by the chronic balance of payments crises of two key reserve currency countries, the US and the UK, leading finally to its disintegration during 1971-73.
4. As reported in *Financial Times*, Feb. 19, 1999.
5. The Basle Concordat established the principles of supervising foreign-owned banking establishments after the Bankhaus Herstatt and Franklin National Bank failures in 1974 nearly touched off a global banking crisis. The Basle Accord established a minimum capital adequacy ratio (CAR) of 8% for observance by all commercial banks.
6. Under the Plaza Agreement, the G-5 (US, UK, France, Germany, and Japan) pledged to work for a gradual depreciation of the US dollar, then considered over-valued. Under the Louvre Accord, the same nations agreed to keep exchange rates stable at current levels. While the official communiqué was rather vague, many economists have interpreted this Accord to be a version of the "target zone".
7. The information in this paragraph has been kindly provided by the HKMA.

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**Global Standards of Capital Adequacy in
Insurance Services**

Dr. Jan-juy Lin

Global Standards of Capital Adequacy in Insurance Services

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Synopsis

The provision of private insurance is an important economic activity. Compared to other sectors of the economy, insurance takes up a special position. In many cases, all the insurers' offer in return for insurance premium already received is the mere promise to perform its obligation if an insured event occurs. Therefore, a fundamental objective of insurance regulation is to ensure insurance companies are able at any moment to fulfill their obligations and sufficiently safeguard the interests of the policyholders.

In terms of its context, insurance regulation can be generally categorized as "market conduct regulation" and "solvency regulation". The former which focuses on ensuring fair and reasonable insurance price, product and trade practices, regulate four aspects of insurance operation: sales and advertising, underwriting, premium rating, and claim settling. Solvency regulation, on the other hand, seeks to protect the policyholders against the insurers' default risk stemming from financial failures, and comprises certain prudential regulatory actions, such as detecting insurers' insolvency, identifying the problem leading to the financial impairment, and implementing corrective actions as early as possible.

Thanks to the global liberalization in trade of insurance services, it becomes prominent in many countries that market conduct regulation is gradually deregulated to promote market efficiency. As a result of drastic and severe market competition, bad managed and inefficient insurers shall be eventually forced to exit from the market. For protecting the interests of policyholders and the public as a whole,

solvency regulation needs to be designed to limit the degree of insolvency risk that an insurer may be involved in.

Except for preserving financial solvency and solidity of the insurance industry, solvency regulation must also provide the regulated insurance industry an opportunity for competing in both local and international markets. If solvency regulation is overly required in an extremely strict approach, it may turn into an obstacle towards the liberalization and development of the insurance market. Prospective insurers may confront market barriers arising from high threshold of regulatory standard. Insurance consumers may, therefore, absorb the additional costs generated by such kinds of solvency regulation.

In this paper, global standards of capital adequacy in insurance services will be addressed as the main theme. In the first place, the concept and functions of insurance capital will be examined. Secondly, the solvency margin mechanism in the European Union (EU) and the Risk Based Capital (RBC) of the National Association of Insurance Commissioners (NAIC) in the USA will be introduced respectively and these two systems will be compared in light of their content. Thirdly, as a case study of this paper, Taiwan's regulatory inefficiency in respect of its capital requirements will be scrutinized. By reference to the global capital standards of insurance discussed, some suggestions will be submitted to the insurance regulatory reform in Taiwan, and might be a useful lesson for other emerging market economies.

Capital Adequacy in Insurance Services -- An Overview on the Current Global Standards

Dr. Jan-juy Lin*

In terms of its context, insurance regulation can be divided into two broad categories: namely, market conduct regulation and solvency regulation. On one hand, market conduct regulations, which are designed to ensure fairness and reasonableness in insurance transactions, regulate the insurance industry in respect of its marketing and advertising, underwriting, premium rating and claim settling. Solvency regulations, on the other hand, are intended to protect policyholders against insurers' default risk stemming from their financial failure.¹ The utmost purpose of solvency regulations is to detect insurers' insolvency as early as possible, to identify the problems leading to the financial impairment, and to implement necessary corrective actions in due course.²

Thanks to the global liberalization in insurance service, it is prominent that the market conduct regulations in many countries have been gradually deregulated to promote market efficiency. Due to the drastic competition at both local and international level, it is expected that many inefficient insurers will eventually withdraw from the market. In order to protect the interests of policyholders and the public as a whole, solvency regulations need to be designed to limit the degree of insolvency risk that an insurer may be involved in.

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¹ Solvency regulation of insurance covers a wide range of regulatory actions, such as capitalization, rating, investment, reinsurance, technical reserves, asset valuation, transaction with affiliates and so on. R.W. Klein, "Insurance Regulation in Transition", in *Journal of Risk and Insurance*, Vol.62 No.3, (1995) at 369.

² See generally K.H. Ettliger, K.L. Hamilton & G. Krohm, *State Insurance Regulation*, at 3-5 (1995); see also Klein, *id.*, at 368.

One significant component of insurance solvency regulations is to maintain the capital adequacy of insurance undertakings. Capital adequacy issue in the insurance sector refers to the minimum level of capital for the operation of an insurance undertaking, viewed as necessary or desirable by the insurance regulators for “safe and sound” operation of insurance business. On one hand, capital or surplus is essential for an insurance undertaking to establish and continue its underwriting operations. Not only the organization cost has to be covered in the initial stage, but also the increase of new business or some large-scale business could cause the exhaustion of surplus and the resultant impairment of its capital. Therefore, unless the insurer repairs its deficit in capital or surplus, it has to stop underwriting additional business for the lack of underwriting capacity.³

On the other hand, sufficient capital or surplus is needed to guarantee an insurer’s continued solvency for a long period of time, enough to let the insurer to detect and correct its adverse underwriting and investment experience. It can provide a cushion against unexpected increases in liabilities and decreases in the value of assets.⁴ It can also fund the expenses in the process of the rehabilitation or liquidation of an insurance undertaking with minimum losses to policyholders, third-party claimant and the public.⁵ Under such circumstances, insurance regulators need to execute some regulatory actions upon the insurer if they can show that it will be unable to meet its obligations.

Furthermore, except for preserving financial solvency and solidity of the insurance industry, capital requirements must be developed to allow the regulated insurance industry have an opportunity to compete in both national and international markets. If they are required in an unreasonable approach or based on an unjustified reason, they might turn into an obstacle towards the liberalization and internationalization of an insurance market. Under such a circumstance, the efficiency of the insurance market

³ See R.I. Mehr, E. Cammack & T. Rose, *Principle of Insurance*, at 751 (8th ed. 1985).

⁴ See S.L. Kimball, “Capital and Surplus Requirements”, in *Insurance, Government, and Social Policy – Studies in Insurance Regulation*, at 63 (S.L. Kimball & H.S. Denenberg, ed., 1969). See also Klein, *supra* note 1, at 369.

⁵ “When an insurer’s capital and surplus falls below the minimum standard, it is considered to be legally impaired. When an insurer’s liabilities exceed the value of its assets, *i.e.* its capital and surplus is negative, it is insolvent.” Klein, *id.*

will be undermined and the insurance consumers may be forced to take the additional costs arising from such regulatory inefficient.

Based on certain unknown reasons, the capital requirements in Taiwan were developed in an extremely conservative approach, particularly in respect of its. Not only did it cause many problems to the market, but also hampered the liberalization and internalization of the local market. At the current stage, it is essential for the insurance regulators in Taiwan to undertake a regulatory reform in this respect. To benefit Taiwan proceed its insurance regulatory reform, it is intended to scrutinize the global standards of capital adequacy in insurance services as the main theme of this paper. In the first place, the concept and functions of insurance capital will be examined. Secondly, the solvency margin mechanism in the European Union (EU) and the Risk Based Capital (RBC) of the National Association of Insurance Commissioners (NAIC) in the USA will be introduced respectively and these two systems will be compared in light of their content. Thirdly, as a case study of this paper, Taiwan's regulatory inefficiency in respect of its capital requirements will be scrutinized. By reference to the global capital standards of insurance discussed, some suggestions will be submitted to the insurance regulatory reform in Taiwan; which might be a useful lesson for other emerging market economies.

1. Concept of insurance capital

“Capital” is not a unitary concept; it is susceptible to differing meanings to different persons under divergent circumstances. This disparity may impair or distort desired regulatory objects and bring into question certain regulatory predisposition toward the capital adequacy issue.⁶ In respect of financial accounts, capital is the net worth of an private enterprise, calculated on the assumption that assets of the enterprise can be liquidated on a going-concern basis, and liabilities and obligation of the enterprise can be paid and satisfied in full. Capital, to the extent it can be translated into monetary value, becomes an integral part of the right-hand side (*i.e.*, the liability and the equity side) of an enterprise's balance sheet.⁷ The final net worth

⁶ See J.J. Norton, “Capital Adequacy Standard: A Legitimate Regulatory Concern for Prudential Supervision of Banking Activities?”, in *Ohio St. L.J.*, Vol. 49: 1299, at 1302 (1989).

⁷ *Id.*, at 1303.

or capital calculation is the sum of the value of nonliability contributions made to the enterprise by its owners, plus retained or undistributed surplus.⁸

Before discussing capital adequacy issue in insurance regulation, it is essential to define the meaning of capital and surplus as applied to the insurance sector. In light of the generally accepted accounting principles (GAAP), capital and surplus which are combined as net worth in the balance sheet and represent the excess of assets over liabilities. With respect to the insurance sector, the capitalization structure of an insurance undertaking depends on its legal corporate form. In the real world, stock companies and mutual companies are two major legal corporate forms adopted by most insurers. By definition, a stock company raises its capital by issuing stocks and its net worth consists of a capital stock account and a surplus account. For a mutual insurer, as there is no capital stock account at all, its capital component, therefore, is represented only by the amount in its surplus account. Furthermore, for an individual insurer (underwriting member) in Lloyd's of London, there is no paid-in capital or surplus at all. In essence, individual insurers in the Lloyd's of London are liable for valid claims on their underwriting to the full extent of their personal assets.⁹

In general, the terminology of insurance capital may vary from country to country. For examples, in the USA, total net worth is often referred as the "*policyholders' surplus*" because the excess of asset over liabilities is available to pay policyholder's claims. In the EU, although the net worth is stated as "*capital and reserves*" on the harmonized balance sheet among the Member States, the mechanism of "*solvency margin*" is designed to ensure the capital adequacy of an insurance undertaking. In Taiwan, the statutory requirements of "*capital and initial fund*" are applied to stock companies and co-operatives respectively. To avoid any unnecessary confusion in definition, except of discussing certain specific jurisdictions, the term of "insurance

⁸ *Id.*, at 1303-1304.

⁹ Under this unique system, the financial resources of members and other assets available are divided into the following categories: (1) assets held in trust to support underwriting at Lloyd's, namely premiums trust funds and funds at Lloyd's; (2) other assets belonging to the members, in excess of the assets held in trust; (3) central resources of Lloyd's. *See generally* Lloyd's of London, *Security Underlying Policies Issues at Lloyd's*, and *Global Result in 1993*. Since 1994, except of individual members, the Lloyd's started to take corporate member groups. *See* Lloyd's of London, *Business Plan Progress Report* (April 1995).

capital” used in this paper will be defined as the final net worth of an insurance undertaking which represents the nonliability value owned by its owners.

2. Functions of insurance capital

In terms of the significance, capital adequacy standards are the linchpin of solvency regulation. As required by such standards, the strength and long-term viability of an insurance undertaking can be measured in light of the insurer’s capital level. In general, insurance capital can function as below in the operation of insurance business:

(a) Providing the financial capacity in the initial stage -- The primary function of insurance capital is to provide the financial capacity in the initial stages of the operation of an insurance undertaking.¹⁰ Like other industries, an insurer has to raise a certain amount of capital to support the costs and expenses for its establishment, such as the costs of new facilities, office furniture, computer systems and so on. The greater the insurer owns its capital, the more flexibly it can cope with the changing demands from a competitive market.

(b) Acting as a safety margin against unforeseen events -- After an insurance undertaking has grown in size, its insurance capital still functions as a financial buffer against unexpected increases in liabilities and decreases in the value of assets. This is because there is always the possibility that unforeseen loss events, for example catastrophes, investment failures, reserving errors, and price inadequacy, may occur. That is to say, insurance capital can play as safety margin against these unforeseen events. Furthermore, insurance capital can cover the expenses and costs occurred in the process of an insurer’s rehabilitation or liquidation and therefore reduce the damages to the policyholders and the claimants to a certain extent.

(c) Supporting the growth in business volume -- Insurance capital can support an insurance undertaking for its growth in underwriting activities. In terms of insurance business, the most significant type of growth is perhaps increases in the volume of written business. What is unique about an insurance transaction is that, under the specific Statutory Accounting Principles (SAP) which adopts a very conservative

¹⁰ See S.L. Kimball, *Insurance and Public Policy*, at 75 (1960).

approach to assess an insurer's financial ability, the acquisition expenses must be recognized at the time of sale instead of being proportioned into the duration of the insurance period. Under such a circumstance, an insurer has to realize an operating loss on each policy as soon as it is sold. Insurance capital then becomes an essential part of an insurance undertaking to support its expansion and growth in its underwriting activities.¹¹

3. Capital Adequacy Standard in the European Union¹²

Under the current EU insurance regulatory regime, the supervisors of home Member State must ensure that their insurance undertakings meet three minimum prudential standards regarding the financial aspect: namely, technical provision, solvency margin and guarantee fund.¹³ Technical provisions need to be calculated and reserved by an insurer to meet all its known liabilities to the policyholders. Solvency margins and guarantee funds, which are designed to maintain insurance capital adequate for both the initial establishment stage and business operational stage, are the most important components of the capital adequacy requirements.

3.1 Solvency margin

¹¹ Ettliger, Hamilton & Krohm, *supra* note 2, at 131-132 (1995).

¹² The European Union is created under art. A of the Maastricht Treaty (Treaty on European Union) with additional powers being conferred on in respect to Common Foreign and Security Policy (art. J) and Home Affairs and Justice Policy (art. K). The basic provisions concerning European insurance and other financial services remain with the renamed European Community Treaty. Reference in this research are, accordingly, to the European Community and not to the European Union. *See* Treaty on European Union, 1992 O.J. (C191).

¹³ The current solvency regulations are mainly based on the provisions of the first generation co-ordination Directives (73/239/EEC for the non-life sector and 79/267/EEC for the life sector). Only the provisions regarding the required solvency in credit insurance and the actual solvency both in life and non-life insurance were amended by the Credit Insurance Directive (87/343/EEC) and the third generation co-operation Directives (92/49/EEC for the non-life sector and 92/96/EEC for the life sector).

“Solvency as referred to by the EC Insurance Directives means the financial resources of an insurance undertaking, *i.e.* in essence the difference between the assets and the liabilities of the insurer. This kind of safety capital is necessary in order to absorb discrepancies between the anticipated and the actual expenses and profits”¹⁴ In other words, solvency margin represents those assets, in addition to technical provisions, which an insurance undertaking must maintain as a measure against its business fluctuations. It consists of any insurance undertaking’s assets that are free of all foreseeable liabilities, less any intangible items.

Generally speaking, the level of solvency margin is linked to the overall business volume of an insurance undertaking conducted in the previous year throughout the EU, based on either premium incomes or claim payments. For a non-life insurer, the minimum solvency margin is determined on the basis either of the annual amount of premium or contributions, or of the average burden of claims for the past three financial years. The amount of the solvency margin is equal to the higher of the premium basis result and the claim basis result.¹⁵ For a life insurer, it is determined according to the classes of insurance underwritten, by reference to capital at risk and mathematical provisions and taking into account reinsurance cessions to a certain extent.¹⁶

3.2 Guarantee fund

Besides the dynamic structure of solvency margin, the so-called guarantee fund¹⁷ is provided to assist the operation of the solvency margin system. In effect, guarantee

¹⁴ See European Union, “Report on Solvency of Insurance Undertakings”, in *Conference of Insurance Supervisory Authorities of the Member States of the European Union*, at 1 (April 1997). The requirement of solvency margin corresponds roughly to policyholders’ surplus (defined as total assets less total liabilities) maintained by US insurance companies as an additional protective measure for policyholders in the event of unexpected or catastrophic losses. See General Accounting Office (USA), *Insurance Regulations in the European Country: Regulatory Issues in Creating a Single Insurance Market*, GAO/GGD-93-87, at 36 (Aug. 1993).

¹⁵ See First Direct Non-Life Insurance Directive, 73/239/EEC, art. 16, 1973 O.J. (L.228/3) .

¹⁶ See First Direct Life Insurance Directive, 79/267/EEC, art.19, 1979 O.J. (L.63/1).

¹⁷ The EU guarantee fund does not correspond to the guarantee fund in the USA which is provided by some states to protect claims against insurance insolvency. Instead, it corresponds more

funds constitute one part of the solvency margin and represent the minimum capitalization requirement that an insurer must possess before obtaining authorization to conduct business. An insurance undertaking must maintain its guarantee fund at a level corresponding to the higher of either one-third of the required solvency margin or a specified absolute level (minimum guarantee fund), which is denominated in European Currency Units (ECU) and determined subject to the classes of the risk the insurer is licensed to underwrite.¹⁸

The objective of the guarantee fund is to ensure not only that an insurance undertaking possesses adequate capital when it is established, but also that in the subsequent course of business its solvency margin shall in no event fall below a minimum level of security.

3.3 Control action of supervisory authority¹⁹

If the solvency margin of an insurance undertaking falls below the statutory minimum level, for the purposes of restoring its financial situation, the supervisory authority of the head office Member State shall require a plan for the restoration of a sound financial position for its approval.

If the solvency margin falls less than the guarantee fund, which is defined as the greater of one-third of the solvency margin or the minimum guarantee fund, the supervisory authority shall require this insurance undertaking to submit a short-term finance scheme for its approval. The supervisory authority may also restrict or prohibit free disposal of the assets of this insurer, and shall inform the authorities of other relevant Member States and may request them to take the same measures.

In any of the above occasions, the competent authorities may further take all measures necessary to safeguard the interests of the policyholders. In implementing

closely to the minimum capital and surplus standards imposed on insurance companies by the state insurance laws.

¹⁸ First Direct Non-life Insurance Directive, art.17, *supra* note 15. *See also* First Direct Life Insurance Directive, art.20, *supra* note 16.

¹⁹ *Id.* First Direct Non-life Insurance Directive, art.20; First Direct Life Insurance Directive, art.24.

these control actions, the supervisory authorities of other Member States should collaborate.

3.4 Review of the current solvency regulatory regime in the EU

According to the third generation insurance directives, the current solvency regulatory regime should be reviewed based on the experience made during their approximately 20-year long application.²⁰ Under such a circumstance, in 1994, the Conference of the Insurance Supervisory Authorities of the Member States of the European Union was created to examine the solvency regulation in more detailed by setting up a working group.²¹

With respect to the investigation of the working group, the working group takes the view that the present solvency margin system has in essence proven its worth. However, some changes and additions are necessary:

- (a) The minimum amounts of the guarantee funds are to be raised considerably to take account at least of the inflation which has occurred since the Directives were adopted. Special provisions should be provided for certain small undertakings.
- (b) The solvency margin in non-life insurance should in future be calculated on the basis of at least three indices: A provision index is to be applied in

²⁰ See art. 25 of the Third Non-life Insurance Directive (92/49/EEC, 1992 O.J. L.228/1) and art. 26 of the Third Life Insurance Directive (92/96/EEC 1992 O.J. L.360/1). According to these directives, the Commission was obligated to submit a report to the insurance committee “on the need for further harmonization of the solvency margin” within three years after the date of application of these directives, *i.e.* by mid-1997 at the latest. See European Union, *supra* note 14, at 2.

²¹ This working group was in particular supposed to: (i) give an overview of the experience supervisory authorities of the member states and examine whether the present definitions of solvency margin would allow the supervisory authorities to intervene early in the case of problems; (ii) examine whether the present formula applied to calculate the minimum solvency requirements still adequately take account of the nature and size of the risks insurance undertakings are exposed to (*e.g.* investment risk, credit risk, underwriting risk, interest risk etc.); and (iii) examine the present provisions in the Directives about the solvency requirements, *e.g.* regarding the quality and admissibility of capital elements, the possible need for “closed-end” definitions, the pros and cons of controlling the investment of assets to cover the solvency margin and the need to up-date the threshold and amounts of the minimum guarantee fund. See *id.*

addition to the premium and claims indices. An agreement could, however, not to be reached on the question as to whether the provision index should be applied alternatively or additively.

- (c) There was no majority support either for the proposal to take account of the investment risk both in life insurance and in non-life insurance by applying a separate investment index.
- (d) The present solvency regulation should be adjusted not only with respect to the minimum amounts of the guarantee funds and solvency margin, but also with respect to the own funds covering them. Although the working group is of the opinion that the own funds mentioned in the Directives should be in principle also be accepted in future, it suggests certain restrictions regarding some components.
- (e) The working group wishes the Directives to state clearly that the supervisory authorities have the right to intervene even if the requirements regarding technical provisions and solvency are still being met, but if the interests of the insured risk being adversely affected.²²

4. Capital Adequacy Standard in the United States of America

In USA, the amount of fixed minimum capital and surplus standards varies among the states. They are more appropriate for start-up operations than they are for established companies with significant premium volume and risk exposure. For example, a capital and surplus of US\$ 2 million would be clearly not enough for a company writing US\$ 50 million in net premiums. In addition, the wide range in size of insurers and the types of risks they assume all can make fixed capital standards inadequate in many occasions. On the other hand, when regulators seek to take actions against trouble insurers before their financial condition fall below the minimum standard, these actions are often subject to legal challenges and the regulators must convince a court that an insurer is in an unsafe condition.²³

²² *Id.* at 41-42.

²³ See R.W. Klein & M.M. Barth, "Solvency Monitoring in the Twenty-First Century", in *Journal of Insurance Regulation*, at 272 (Spring 1995).

Due to the limitation of fixed capital standards, the model risk-based capital (RBC) system was introduced by the National Association of Insurance Commissioners (NAIC)²⁴ in 1992. At present stage, many states have transformed this model law into their insurance legislation as a supplemental capital requirement. For example, the California State has applied it to both life and non-life insurance sectors while the New York State applies it only to the life sector.²⁵

4.1 Fixed sum capital

In the USA, the fixed sum capital requirements have been specified in the state insurance legislation to ensure that applicants seeking a license to conduct insurance business within the state jurisdiction have sufficient capital to support underwriting activity. The requirements of minimum capital and minimum surplus vary primarily according to three factors: namely the company's legal form, the lines of insurance that the company intends to underwrite, and the state where the company is seeking for a license.²⁶

Generally speaking, in the capital requirements of most states, minimum capital and minimum surplus are provided separately. Furthermore, minimum surplus requirements for new insurers are usually stated separately from minimum surplus for existing insurers. Under such a scenario, a new stock insurer must provide an "initial free surplus" which represents a specified amount of surplus above the "minimum statutory capital", but an existing stock insurer only needs to maintain a "minimum statutory basic surplus" to continue its insurance business. On the other hand, for a mutual insurer, because of no capital stock account, the concept of "minimum statutory capital" is therefore replaced by a "minimum statutory basic surplus".

²⁴ Insurance regulation in the USA is proceeded by the individual states. A certain degree of harmonization of the principles of regulation has been reached by the NAIC, which is a private association and does not have any explicit legislative powers. Its activities are aimed at harmonizing legislation and achieving stricter solvency control in the individual states, thereby facilitating individual state licensing and supervision. *See* Swiss Re., "Development of Insolvencies and Importance of Security in the Insurance Industry", in *Sigma*, No. 7, at 19 (1995).

²⁵ *See generally* Cal. Ins., Sec. 739-739.12 and NY Ins., Sec. 1322.

²⁶ Ettliger, Hamilton & Krohm,, *supra* note 2, at 156-157.

Nevertheless, in addition to the “minimum statutory basic surplus”, an additional “initial free surplus” must be provided by a new mutual insurer.²⁷ For example, in the New York State, a stock life insurance company may be organized and licensed to do the business of life insurance as with a paid-in capital of at least US\$ 2 million and a paid-in initial surplus at least equal to the greater of US\$ 4 million or two hundred percent of its capital.²⁸ On the other hand, for a mutual life insurer, it shall have an initial surplus of one hundred fifty thousand dollars in cash; and have a minimum surplus of one hundred thousand dollars.²⁹

4.2 Risk-based capital (RBC)

As insurance business involves assumption of risk, the business risk on insurance is much more severe than on other business. The effect of market and financial risk on insurers are compounded by the additional risks they assume in their underwriting activities. Therefore, insurance capital is essential for the growth of insurance business and provides a buffer against risk and uncertainty encountered by an insurance undertaking. As a new insurance undertaking is not exposed to the compound effect of market, financial and underwriting risks, fixed sum capital requirements should be adequate for its operation. Nevertheless, as various risks occur and increase with the growth of business, an insurance undertaking must increase its capital to a certain level to ensure capital adequate for its operation. Because fixed sum capital requirements can not respond to various risks inherent in the business, such capital standards may be inappropriate in many occasions.³⁰

Addressing the problems inherent in traditional fixed sum capital requirements, the NAIC adopted model minimum risk-based capital (RBC) requirements for life insurers in 1992 and for property/casualty insurers in 1993 which are intended to

²⁷ *Id.*, at 15-18.

²⁸ *See generally* N.Y. Ins., Sec. 4202.

²⁹ For a mutual life insurer in New York State, “initial surplus” means the paid-in initial surplus required pursuant to paragraph nine of subsection (a) of section 1201 and paragraph one of subsection (e) of section 1102. “Minimum surplus” means the amount of surplus which such company shall, after being licensed to do business, at all times maintain unimpaired. *See id.*, Sec. 4208.

³⁰ Ettliger, Hamilton & Krohm, *supra* note 2, at 157-158.

correct the deficiencies of fixed sum capital standards. The objectives of the RBC requirements are to provide a standard of capital adequacy that: (i) is related to risk, (ii) raises the safety net for insurers, (iii) is uniform among states, and (iv) provides authority for regulatory action when actual capital falls below the standard³¹

The RBC model develops an insurer capitalization requirement based on the risk characteristics inherent to the insurer's unique operations. Regarding the RBC model for property/casualty insurers, four major categories of risk are addressed as below:

(a) Off-balance sheet risk -- which includes the risk associated with abnormal premium and reserve growth, investment in affiliates, and financial guarantees made on behalf of an affiliate.

(b) Asset risk -- which presents the risks associated with market volatility that can affect the value of an insurer's invested assets and the security of those investment.

(c) Credit risk -- which is related to the collectibility of the insurer's receivables, including reinsurance recoverables and agents' balances due the insurer.

(d) Underwriting risk -- which consists of a component for the net written premium risk which represents those risks associated with price inadequacy, when the loss exposure of assumed risks is deliberately (because of competitive pressure) or unintentionally mispriced. The underwriting risk also includes a net loss reserve and a loss adjustment expense risk component recognizing those risks associated with reserving errors.³²

On the other hand, the risks addressed in the life/health RBC model are similar to the property/casualty model in some aspects and different in others, including: asset risk, insurance or pricing risk, interest rate risk and business risk. Asset risk encompasses the risk of default and market value declines of an insurer's investment portfolio. Insurance or pricing risk refers to the potential that premiums and reserves are inadequate to cover benefit payments. Interest rate risk addresses the possibility that an insurer will have liquidity problems from disintermediation due to interest rate

³¹ Klein & Barth, *supra* note 23, at 272-273.

³² Ettlinger, Hamilton & Krohm, *supra* note 2, at 158-159; *see also* Cal. Ins., Sec. 739.2 (c).

changes. Business risk refers to an insurer’s potential obligation for guaranty fund assessments.³³

These risk categories are combined in accordance with a specific formula to determine the total RBC amount. A covariance adjustment is made to the accumulated RBC charge to account for diversification among major risk categories. The resulting adjusted total RBC amount is compared to an insurers actual “total adjusted capital” (TAC) to determine its RBC position. Insurers are required to report their RBC and TAC in their annual statements but the details of their calculations are filed in a confidential report.³⁴

In addition, under the *Risk-Based Capital (RBC) for Insurers Model Act*, specific duties are provided for both the insurers and the regulators based upon the figures generated by the RBC formulas. Certain company and regulatory actions are required if an insurer’s TAC falls below a certain levels of RBC. Under such a scenario, four different RBC levels have been established, including:

- (a) company action level,
- (b) regulatory action level,
- (c) authorized control level, and
- (d) mandatory control level.

Figure 1 Risk-Based Capital Levels

RBC Level	Percentage of Authorized Control Level RBC	Action Required
Company Action Level	200 percent	Insurer files comprehensive plan
Regulatory Action Level	150 percent	Regulator performs exam as necessary; Insurer files comprehensive plan
Authorized Control Level	100 percent	Regulator may seize control

³³ Klein & Barth, *supra* note 23, at 273; *see also* Cal. Ins., Sec. 739.2 (a) And N.Y. Ins., Sec. 1322 (c).

³⁴ *Id.*

Mandatory Control Level	70 percent	Regulator required to place insurer under regulatory control
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Source: Ettliger K.H., Hamilton K.L. & Krohm G., *State Insurance Regulation*, p160 (1995)

The respective actions are required by the Act to meet each position between these levels. As illustrated in the Figure 1, if an insurer's actual capitalization is between the highest (company action) level and the second (regulatory action) level, the insurer has to submit to the regulator a comprehensive financial plan containing proposals to correct the company's financial problems. If an insurer slips between the second level and the third (authorized control) level, the regulator can perform an examination or analysis as deemed necessary and the insurer also needs to file a comprehensive financial plan. If the actual capitalization is between the third level and fourth (mandatory control) level, the regulator can place the insurer under regulatory control but is not required to do so. If actual capitalization falls below the lowest threshold, the regulator is required to place the insurer under regulatory control. The authorized control level is considered as the minimum capitalization level that an insurer should maintain.³⁵

5. Interim summation

Following the discussion above, it can be recognized that the capitalization structure of an insurance undertaking depends on its legal corporate form. A stock company raises its capital by issuing stocks and its net worth consists of a capital stock account and a surplus account. For a mutual insurer, as there is no capital stock account at all, its capital component, therefore, is represented only by the amount in its surplus account.

In general, insurance capital at least possesses three functions for the operation of insurance business, *i.e.* the financial capacity in the initial stage, the safety margin against unforeseen events and the necessary supports for insurers' growth and

³⁵ Ettliger, Hamilton & Krohm, *supra* note 2, at 160-161; *see also* Cal. Ins., Sec. 739.3-739.6 and N.Y. Ins., Sec. 1322(d)(e)(f)(g).

underwriting activities. Furthermore, in the process of the rehabilitation or liquidation of an insurance undertaking, it can fund the expenses with minimum losses to policyholders, third-party claimant or even the public.

Traditionally, a fixed sum capital mechanism adopted in most jurisdictions function as the fundamental capital requirement in respect of insurance solvency regulation. However, a fixed sum capital standard is unable to reflect the practical business risks that an insurer may be involved in. The statutory amounts required by legislation might be too low or high for an individual insurer. On many occasions, it often lacks of a sufficient basis for prompt regulatory action against a failing insurer. To provide more advanced skills to deal with solvency risks in insurance operations, the Solvency Margin model and the RBC model were developed by the EU and the NAIC respectively. In essence, such capital mechanisms may be treated as the global standards in respect of the capital adequacy issue because these two economic regions dominate a very significant volume in global insurance market.

At least two significant advantages can be found within such risk-related capitalization models: first, they can reflect an estimation of actual risks to which an insurer is exposed rather than to apply a fixed sum capitalization level regardless of the insurer's specific operations. Secondly, they can establish specific responsibilities for both regulators and insurers if the required capitalization levels are not maintained.³⁶

In light of their contents addressed above, several characteristics in common can be found in comparison of the RBC with the Solvency Margin Model. First, in both models, a basic fixed sum capital standard is supplemented by a dynamic risk based capital mechanism. In the EU, when a guarantee fund represents the element of statutory fixed sum capital, a statutory solvency margin acts as a variable safety net to maintain the adequacy of an insurer's capital. In the USA, the fixed sum capital element is reflected in the statutory minimum capital and surplus required by each state. The RBC system, although not being adopted by all the states yet, provides a comprehensive mechanism to combine most risks of insurance business to determine the adequate capital needed by an insurance undertaking.

³⁶ Ettliger, Hamilton & Krohm, *id.* at 161.

Secondly, either the Solvency Margin model or the RBC model can provide a function of consistency among the (member) states with respect to the insurance capitalization requirements. It can harmonize the regulatory difference among the (member) states and promote regulatory efficiency in these economic regions.

Thirdly, these two models specify the necessary regulatory actions for regulators and regulated insurers if the required capital levels can not be maintained. In the EU, the supervisory authority of the head office Member State has different regulatory actions to proceed in the cases that solvency margin of an insurance undertaking falls below the statutory minimum level or the guarantee fund. In the USA, the *Risk Based Capital for insurers Model Act* drafted by the NAIC provides four different control levels. The regulators are responsible to execute the required actions in accordance with the RBC level on which an insurer is situated. Under these mechanisms, some unnecessary judicial proceeding can be avoided and prompt regulatory intervention can be proceeded so as to prevent the financial impaired or insolvent insurer from further deterioration or potential abuses.

Regarding the differences between these two models, the Solvency Margin model currently applied in the EU seems less complicated than the RBC model of the NAIC while assessing the capital adequacy of an insurance undertaking. Although the EU Solvency Margin model is, in essence, a kind of risk-based capital assessment on an insurance undertaking's capital level, it is likely to be less accurate in assessment of the risk based capital for an insurance undertaking. Since such a model mainly takes into account of the factors of premium and claim, it neglects other important and relevant factors such as investment risk and credit risk. It means that it may be not accurate enough to measure the adequate capital needed for an insurer in its operation. Neither could it recognize the differences and characteristics among insurers in an equal approach. It means that such a model may also confront the problems arising from the traditional fixed sum capital mechanism.

6. Regulatory inefficiency of the capital standards in Taiwan

Ensuring financial security of insurance industry is an important objective of insurance regulation, but not the only one. Insurance regulators need to strike a

balance between different regulatory objectives to attain regulatory efficiency. If the regulators focus only on one particular objective and ignore the others, it will be difficult to achieve a sound and efficient regulation.

In Taiwan, it is a conventionality for most insurance regulators that no insurance undertaking is allowed to fail, or even go into bankruptcy. From the viewpoint of the government, any insurance failure will eventually cause turmoil to the society in the economic, social or even political aspects. Under such a scenario, the solvency regulatory system in Taiwan was designed to prevent insurers from insolvency without taking into account of other associate costs. It means that market competition and efficiency may be therefore neglected or forfeited under such a regulatory regime.

In order to promote the efficiency of the insurance regulation and enhance market competition in respect of the global liberalization in insurance service, Taiwan has conducted several significant revisions of the Insurance Law and relevant Regulations in recent years. However, certain practical problems, arising from regulatory inefficiency in the capital adequacy standards, contribute an adverse effect toward the development of the insurance market.

In Taiwan, the capital requirements to regulate an insurance undertaking's financial solidity consist of three basic components: namely, a minimum fixed-sum capital (for an insurance stock company) or an initial surplus (for an insurance cooperative), a solvency margin and a mandatory deposit. Under the current regulatory regime, the minimum statutory paid-in capital or initial surplus shall be approved by the Executive Yuan by reference to the recommendation from the competent authority (the MOF). The required amount should be subject to the actual condition of local market and the characteristics of each insurance business class. At the current stage, the minimum statutory paid-in capital required for establishing a domestic insurance company is NT\$ 2 billion (around US\$62 millions).³⁷

A solvency margin, which denotes the balance of the admitted assets deducted by the liability of an insurance undertaking, represents the capital level maintained by the

³⁷ See the Insurance Law (ROC), Sec. 139 (1); see also the Criteria for Establishing an Insurance Company (ROC), Sec. 2. For a foreign insurer, a minimum operational fund is required for setting up its branch office in an amount no less than NT\$ 5 million. See the Insurance Law (ROC), Sec. 137(5), and the Criteria for Granting Approval to and Administration of Foreign Insurance Companies (ROC), Sec. 8.

insurer. If an insurer's solvency margin falls below the amount equaling to 300 % of its mandatory deposit³⁸, the competent authority shall order the insurer to make up such difference in cash within a specific period of time. Since the amount of mandatory deposit, lodged by an insurance undertaking at the National Treasury, is 15% of the total paid-in capital, the minimum solvency margin of an insurance undertaking shall, therefore, not be less than 45 % of its paid-in capital.³⁹

Because the capital requirements adopt a fixed-sum approach to determine the minimum level of an insurer's solvency margin, they cannot adequately respond to the actual business risks related to the insurer's business operation. Lacking of a flexible mechanism to determine the adequate capital level needed, such a regulatory regime inevitably creates several problems to the insurance industry. One significant problem is that an unfair market competition between new insurers and old insurers may arise. Very often, it is severely criticized that the "old insurers", who conduct much more business volume, are only required to maintain the same solvency margin as the "new insurers".⁴⁰ That is to say, no matter what difference in the aspects of business volume, claim experiences and investment portfolios, as long as an old insurer has the same paid-in capital level as a new insurer (e.g. NT\$ 2 billion), both of them are subject to the same solvency margin requirement (i.e. NT\$ 900 million, 45% of the paid-in capital). In fact, some old insurers are even subject to a lower capital requirement at current stage. This is because certain new capital requirements still have not applied to them completely.

In terms of quantitative concern of fixed-sum capital, the minimum statutory capital for setting up a new insurance company in Taiwan is extraordinarily large. Regarding the average level of other Asian countries, except the Mainland China⁴¹, the

³⁸ Before the revision of the Insurance Law in 1997, the minimum solvency margin equaled to the statutory minimum capital (or initial fund). *See* the Insurance Law (ROC), Sec. 143.

³⁹ *Id.* Sec. 141.

⁴⁰ In this connection, a "new insurer" refers to an insurer who was established after 1992 and subject to the new establishment rule. An "old insurer" refers to an insurer who was established before 1992 and subject to the old establishment rule. In light of the minimum statutory paid-in capital, the new rule is much stricter than the old one.

⁴¹ In China, the minimum Registered Capital required for the establishment of an insurance company is RMB 200 million (around US\$ 25 million). The minimum Registered Capital of an insurance company must be paid-in currency capital funds. The departments in charge of financial

absolute volume for minimum statutory capital per company are well below US\$ 4 million.⁴² In the developed countries such as the USA and the EU, the minimum statutory paid-in capitals are still much less than the ones required in Taiwan. In consideration of their operation costs, most foreign insurance undertakings, therefore,

supervision and regulation shall, in accordance with the business scope and scale of an insurance company, adjust its minimum Registered Capital; provided, however, the adjusted minimum Registered Capital shall not be lower than the minimum requirement defined as above. In such a scenario, the paid-in capital required to establish is RMB 500 million (around US\$ 62.5 million) for establishing a national insurer, RMB 200 million (around US\$ 25 million) for an insurer in a specific district. *See Insurance Law (PRC), Sec. 72. & Provisional Regulation on Administration of Insurance Enterprises (PRC), Sec. 5.*

⁴² *See generally* Swiss Re., “Asia’s insurance industry on the rise: into the next millennium with robust growth?” in *Sigma*, No. 6 (1996).

In Hongkong, an insurer carrying on solely general business or long-term business is required to have a minimum paid-up capital of HK \$10 million (around US\$ 1.2 million). For an insurer carrying on both general business and long-term business or carrying on any statutory insurance business, the minimum amount is HK \$20 million (around US \$ 2.4 million). The minimum paid-up capital for a captive insurer, however, is HK \$2 million (around US\$ 0.24 million). As to the solvency requirement, an insurer shall maintain an excess of assets over liabilities of not less than a required solvency margin. An insurer carrying on general business shall maintain a solvency margin determined on the “premium income basis” or the “claim outstanding basis”, whichever is the greater, and subject to a minimum of HK\$ 10 million. (HK\$ 20 million if the insurer is authorized to carry on compulsory insurance business.) In respect to long term business, the solvency margin shall be determined in accordance with the Insurance Companies (Margin of Solvency) Regulation, subject to a minimum of HK\$ 2 million (around US\$ 0.25 million). The solvency margin is generally the aggregate of two components: a percentage of mathematical reserves and a percentage of the capital risk. Furthermore, a captive insurer shall maintain a solvency margin determined on 5% of the net premium income or 5% of the net claims outstanding, whichever is greater, and subject to a minimum of HK \$2 million (around US\$ 0.25 million). *See generally* the Insurance Companies Ordinance (Hong Kong), Sec. 7.

In Singapore, an insurer carrying on direct written business is required to have a minimum paid-up capital of S\$ 5 million (around US\$ 3 million). For establishing a professional reinsurer, the minimum paid-up capital is S\$ 10 million (around US\$ 6 million). For establishing a captive, the minimum paid-up capital is S\$ 1 million (around US\$ 0.6 million). In respect of their business in Singapore and overseas, each insurer, professional reinsurer and captive insurer is required to maintain a solvency margin which is subject to the greater of a statutory minimum amount (S\$ 1~ 5 million), its net premium income level and its loss reserves level. *See generally*, the Insurance Companies Act 1994 (Singapore), Sec. 8 & 17; *see also* the Insurance Companies Regulation 1992 (Singapore), Sec. 2 & 3.

prefer to operate insurance business in Taiwan via a branch or a liaison office, rather than a subsidiary⁴³.

Under such a capital mechanism, the development and internationalization of the Taiwan insurance market is therefore hampered to a significant extent. Regarding its market scale at the global stage, it seems that the Taiwan insurance market has a moderate scale because its world ranking was 14 in terms of premium volumes in 1996.⁴⁴ However, in assessing the actual degree of the development of the insurance market, Taiwan only ranked 17th in the world in terms of “insurance penetration”⁴⁵ and 26th in terms of “insurance density”⁴⁶. Both these two figures show that the insurance market is less developed than the other Asian newly industrial market economies, particularly the South Korea.⁴⁷

7. Suggestion

By reference to the capital mechanisms of the EU and the USA and the fundamental regulatory principles addressed above, it is suggested that at least two

⁴³ The required minimum operational fund for a foreign insurance undertaking’s setting its branch in Taiwan is only NT\$ 50 millions (around US\$ 1.6 million).

⁴⁴ The comparison of premium volumes is often distorted by the different weightings of individual market. In general, while determining the degree of the development of an insurance market, “insurance penetration” and “insurance density” are two figures needed to take into consideration. Not only they can provide more accurate information on the importance of the insurance industry in these markets, but also can additionally draw attention to structural differences.

⁴⁵ “Insurance penetration” (premium volumes as % of GDP) measures the significance of the insurance industry in relation to a country’s entire economic productivity. This figure provides a good indication of the stage of development of an insurance market. *See generally* Swiss Re., “World insurance in 1995: premium volume exceeds USD 2000 billion for the first time”, in *Sigma*, No. 4, at 14 (1997).

⁴⁶ “Insurance density” (premium per capita in currency) indicates how much the inhabitant of a country spends on average on insurance. This figure provides an indication of the insurance purchasing power in a country. *See id.*

⁴⁷ In 1996 the world ranking by the “insurance density” of South Korea, Singapore and Hong Kong were 17, 18 and 21 respectively. As to the “insurance penetration”, they were 2, 26 and 33 respectively. *See generally* Swiss Re., “World insurance in 1996: Modest growth in the insurance industry”, in *Sigma*, No. 4, at 28-29 (1998).

important issues need to be observed by Taiwan or any other developing markets economies in respect of proceeding the insurance regulatory reform in the future:

First, various dynamic business risks in the process of insurance operation should be recognized.

Due to the complexity and diversity of the business risks inherent in insurance operations, a statutory fixed-sum capital mechanism can no longer adequately reflect to the actual business environment where an insurance undertaking is situated. It means that those dynamic risk factors associated with the operation of the insurance business need to be recognized comprehensively in the body of solvency regulation. Knowing this, the EU and the USA developed their own risk-based capital systems respectively to enhance their insurance solvency regulation.

In light of its current provisions in force, Taiwan seems to have a similar regulatory mechanism to the one in the EU. However, if we examine it thoroughly, it can be easily found that the required statutory solvency margin is still subject to a fixed-sum mechanism, rather than being flexibly or dynamically responsive to the actual business situation in which an insurance undertaking is involved. This is because the amount of minimum solvency margin is still subject to a fixed percentage of the paid-in insurance capital, *i.e.* 45% of the paid-in capital of an insurer. It is unfair for the newly established insurers who have very low business volumes but shall maintain the same or higher solvency margin level than some old insurers.

Most significantly, such a solvency margin mechanism is unable to be adjusted automatically when an insurer's written business increases dramatically or its underwriting result gets deteriorated. That is to say, it might be inadequate for many insurers in the market if they do not initially themselves to increase their paid-in capitals in due course even though their business is in growth or situated in a financial instability. Obviously, it contradicts the fundamental objective of solvency regulation -- financial solidity and soundness of insurance industry. Accordingly, it is suggested that the current fixed-sum capital mechanism in Taiwan needs to be supplemented with a dynamic or risk-related capital mechanism to deal with the associated risks in the operation of insurance business.

Second, the minimum amount of statutory paid-in capital needs to be reduced to a reasonable level.

As mentioned above, the minimum amount of paid-in capital for setting up an insurance company in Taiwan is much higher than the ones in other Asian countries, perhaps the highest in the world. Based upon an extremely conservative scenario, such a high fixed-sum capital standard was conducted in very rough approach. From the insurance regulators' point of view, the more paid-in capital an insurer submits, the more financial solidity of an insurer can be secured. In fact, although insurance capital can ensure financial security and contribute significantly to the growth of an insurer to a certain extent, high volume of insurance capital does not definitely guarantee the safety and efficiency of insurance business. If insurance capital can not be well managed to achieve its primary functions, the associate costs tend to be transferred indirectly to the policyholders. As a result, policyholders' interests might be impaired by the additional costs arising in insurance transactions.

After examining the systems in the EU and the USA, it is understood that the main purpose of statutory minimum capital requirements is to cover the working costs and expenses at the initial stage, and support its business underwriting to a limited extent. Regarding other relevant associated risks at the on-going operation stage, they shall be dealt with by means of dynamic risk capital mechanisms. Under such a scenario, it seems awkward and unreasonable to require an insurer to submit a large capital at its initial establishment stage. For promoting a further development of the insurance market, it seems necessary for Taiwan to reduce the minimum volume of paid-in capital significantly to the extent that it is can reasonably cover the costs for a new insurer's initial operation.

**The Conglomerate Challenge - Financial
Market Integration and Financial
Risk Control**

Dr. G.A. Walker

1. **Financial Innovation** [1] **Product Innovation**
[2] **Market Restructuring**
2. **Conglomerate Structures**
 - 1.1 **Banking Markets**
 - 1.2 **Securities and Investment Services**
 - 1.3 **Insurance Undertakings**
3. **Conglomerate Development**
4. **Conglomerate Advantage**
5. **Conglomerate Risk and Conglomerate Control**
6. **International Regulatory Response**
 - 6.1 **Basle Committee -
Principles for the Supervision of Financial Conglomerates,
September 1992**
 - 6.1.1 **Conglomerate
Supervision Difficulties**
 - [1] *Contagion*
 - [2] *Double-gearing*
 - [3] *Risk mixing*
 - [4] *Intra-group Exposures*
 - [5] *Conflicts of Interest*
 - [6] *Management Autonomy*
 - [7] *Dispersion of Control*
 - [8] *Transparency*
 - 2.2 **Principles
of Supervision**
 - [1] *Scope*
 - [2] *Information and Consolidation*
 - [3] *Capital Strength*
 - [4] *Organisation*
 - [5] *Ownership*
 - [6] *Risk Control*
 - [7] *Connected Transactions*
 - [8] *Management*
 - [9] *External Audit*
 - 2.3 **Methods of Supervision**
 - [1] *Co-operation*
 - [2] *Lead Regulator*
 - [3] *Individual Supervisor*
 - 6.2 **IOSCO -
Principles for the Supervision of Financial Conglomerates,
November 1992**
 - 6.3 **Tripartite Group of Banking, Insurance and Securities Regulators**
 - 6.3.1 **Progress Report on the Supervision of Financial
Conglomerates, April 1994**
 - 6.3.1 **Supervisory Approach**
 - 6.3.2 **Co-operation**

- 6.3.3 Supervision [1] Capital Adequacy
[2] Structure
[3] Ownership
- 6.3.4 Contagion
- 6.3.5 External Auditors
- 6.3.6 Supervisory Arbitrage

6.3.2 Report on the Supervision of Financial Conglomerates, July 1995

6.3.2.1 Financial Conglomerates and Conglomerate Structure

6.3.2.2 Supervisory Issues

- (i) Overall Approach to Supervision
- (ii) Assessment of Capital Adequacy
 - (1) *Building Block Prudential Approach*
 - (2) *Risk-Based Aggregation*
 - (3) *Risk-Based Deduction*
- (iii) Contagion
- (iv) Intra-Group Exposures
- (v) Large Exposures at Group Level
- (vi) Conflicts of Interest
- (vii) Fit and Proper Tests for Managers
- (viii) Transparency of Legal and Managerial Structures
- (ix) Management Autonomy
- (x) Suitability of Shareholders
- (xi) Rights of Access to Prudential Information
- (xii) Supervisory Arbitrage
- (xiii) Moral Hazard
- (xiv) Mixed Conglomerates

6.4 Joint Forum -

6.4.1 Progress Report on the Supervision of Financial Conglomerates, April 1997

6.4.2 The Supervision of Financial Conglomerates, February 1998

- [1] Capital Adequacy Principles Paper
- [2] Supplement to the Capital Adequacy Principles Paper
- [3] Fit and Proper Principles Paper
- [4] Framework for Supervisory Information Sharing Paper
- [5] Principles for Supervisory Information Sharing
- [6] Coordinator Paper [Supervisory Questionnaire]

6.4.3 The Supervision of Financial Conglomerates, February 1999

7. International Supervisory Cooperation and Lead Regulation

8. Conglomerate Supervision and Regulation - Conclusions and Comment

THE UNIVERSITY OF HONG KONG, FACULTY OF LAW

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**THE CONGLOMERATE CHALLENGE -
MARKET INTEGRATION AND FINANCIAL RISK CONTROL**

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Conglomerates

Any form of business structure in which, at least, two distinct forms of industrial activity or service provision are involved. This usually involves groups of companies in one, or more, industrial or commercial sector, although the term may also include a single corporate entity which provides more than one distinct industrial or commercial service.

A financial conglomerate is a single company or group of companies which provides at least two distinct forms of financial service. This includes, for example, an integrated investment house which provides a range of financial services through internal Chinese Walls, or a group of connected financial companies with the most serious recent concerns being expressed in connection with the provision of banking, securities and insurance services from within the same group.

A mixed, or mixed-activity, conglomerate is a group of companies involved in various industrial or commercial sectors with, at least, one unit which provides financial services from one of the three principal service areas referred to.

Conglomerate Advantage

Conglomerate structures have become important in terms of business strategy due to the very significant improvements possible in terms of operational efficiency and effectiveness. These benefits arise from economies of scope and scale which generate lower costs, reduced prices and improved product and service innovation. At the same time, sector synergies can substantially increase the general competitiveness of the business.

The stability of each of the structural components of a particular organisation, as well as the business as a whole, can also be significantly improved through diversified revenues and risks while product variety and innovation can increase customer loyalty and market penetration and development.

Against the perceived benefits of conglomeration, however, must be set the possible dangers of resource depletion and concentration as well as new, or aggravated forms, of financial, or legal risk, which arise especially with regard to the mixing of commercial and investment banking and banking and insurance services

Conglomerate Risk

(1) Intra-Group or Conglomerate Risk

[a] Intra-Group Financial Exposure

[i] Draw-down Facilities

[ii] Loans

[iii] Guarantees

[b] Capital Allocation

[c] Central and Localised Management

[d] Internal Systems and Controls

[and Conflicts of Interest]

[e] Crisis Management

(2) Extra-Group or Market

[a] Sector Specific Loss and Contagion

**[b] Cross-Sector Contagion and Larger
Systemic Damage**

Conglomerate Controls

(1) Intra-Group or Conglomerate Risk

- [a] Supervision - Operational Issues**
 - [i] Consolidated Supervision**
[Significant Business Units]
 - [ii] Co-operation**
[MoUs/Lead Regulation]
- [b] Financial Regulation**

(2) Extra-Group or Market

- [a] Pre-Crisis**
 - [i] Structural Regulation**
 - [ii] Capital Absorption**
 - [b] Post-Crisis - Extended LLR**
-

**Conglomerate Supervision -
Supervisory Transparency and Systemic Controls**

- 1. Conglomerate Structures**
 - 2. Financial and Mixed Conglomerates**
 - 3. Conglomerate Advantage**
 - 4. Conglomerates and the Risk of Loss Transfer**
 - 5. Structural Regulation**
-

6. International Regulatory Responses

I. Basle Committee -

Minimum Standards for Supervision

**II. Basle Committee - Principles for the Supervision
of Financial Conglomerates**

(a) Conglomerate Supervision Difficulties

- (i) Contagion**
 - (ii) Double-Gearing**
 - (iii) Risk Mixing**
 - (iv) Intra-Group Exposures**
 - (v) Conflicts of Interest**
 - (vi) Management Authority**
 - vii) Dispersion of Control**
 - (viii) Transparency**
-

II. Basle Committee - Principles for the Supervision of Financial Conglomerates

(b) Principles of Supervision

- (i) Ambit of Supervision**
- (ii) Information and Consolidation**
- (iii) Capital Strength**
- (iv) Organisation**
- (v) Ownership**
- (vi) Risk Control**
- (vii) Connected Transactions**
- (viii) Management**
- (ix) External Audit**

(c) Methods of Supervision

- (i) Co-operation**
 - (ii) Lead Supervisors or Regulators**
 - (iii) Individual Supervisor**
-

- III. IOSCO - Principles for the Supervision of Financial Conglomerates**

 - IV. Tripartite Group of Banking, Insurance and Securities Regulators - Progress Report on the Supervision of Financial Conglomerates**

 - V. Tripartite Group of Banking, Securities and Insurance Regulators - Report on the Supervision of Financial Conglomerates**

 - VI. Joint Forum - Interim Report on the Supervision of Financial Conglomerates**
-

VII. Joint Forum -

Supervision of Financial Conglomerates

- [1] Capital Adequacy Principles Paper**
- [2] Supplement to the Capital Adequacy Principles Paper**
- [3] Fit and Proper Principles Paper**
- [4] Framework for Supervisory Information Sharing Paper**
- [5] Principles for Supervisory Information Sharing**
- [6] Co-ordinator Paper**

Supervisory Questionnaire

7. International Supervisory Cooperation and Lead Regulation

8. Conglomerate Supervision - Lead Regulation and Systemic Controls

**International Lead Regulation -
Effective Conglomerate Supervision and An Integrated
Systems Revision**

- 1. Supervisory Integration and Co-operation Models**
 - I. Exclusive National Bank Supervision**
 - II. Informal Bilateral Contacts**
 - III. Formal Bilateral Contacts and Multilateral
Contacts**
 - IV. College Supervision**
 - V. Lead Regulation**
 - 2. Historical Precedents**
 - I. UK**
 - II. EC**
 - III. International**
 - 3. Appointment or Identification Options**
 - I. Parent Undertaking's Operational
Supervisor**
 - II. Consolidated Supervisor of Parent
Undertaking**
 - III. Consolidated Supervisor of Group**
 - IV. Supervisors of Dominant Securities
Operation within Group**
-

- V. Most Experienced Supervisor of Core Group Activities**
 - 4. Functions or Responsibilities of Lead Regulator**
 - I. Information Collection and Distribution**
 - II. Group Risk Assessment**
 - III. Group Risk Control Analysis**
 - IV. Crisis Management**
 - V. Enforcement Measures**
 - VI. Subsequent Disciplinary Actions**
 - VII. Crisis and Collapse Investigations and Reporting**
 - VIII. Remedial Action**
 - 5. Supervisory or Systems Value - Advantages of Lead Regulation**
 - 6. Difficulties and Source Objection**
 - I. Structural and Support Difficulties**
 - II. Operational and Procedural Difficulties**
 - III. Funding and Liability Difficulties**
 - IV. Systems Review and Continuing Development**
 - 7. An Interim Response**
 - 8. Conclusions and Comment**
-

7. Conglomerate Law - A Provisional Response

**I. Lead Regulation and
Supervisory Equivalence**

**II. Loss Transfer - Structural Regulation and
Capital Adjustment**

III. Residual Structural Conflicts

IV. Internal Risk Management

V. Crisis Management and Market Support

**8. Conglomerate Supervision -
Lead Regulation and Systemic Controls**

THE CONGLOMERATE CHALLENGE - MARKET INTEGRATION AND FINANCIAL RISK CONTROL

As the use of corporate conglomerate structures has become one of the most dominant forms of business in many national and international industrial and commercial sectors, it is essential that such operations are subject to proper legal and financial control in so far as they may otherwise create additional forms of risk not covered by existing commercial laws or regulatory practices.¹

Although the 1990s have experienced a large amount of industrial restructuring through the disposal of various non-core activities in many sectors, the development of increasingly complex conglomerate business structures in the financial services area remains one of the most important forms of business expansion.² The development of appropriate legal responses to the difficulties created by these new conglomerate forms of business has, however, been slow until now.

One specific difficulty which arises in connection with the development of financial conglomerates or mixed conglomerates, which include at least one financial component in addition to their industrial or commercial operations, is that new forms of financial exposure or legal risk arise as a result of the new commercial and corporate relationships created within the conglomerate structure in connection with which it is essential that new forms of financial supervision and regulation are developed.

In contrast with such product related developments as the very substantial growth in the use of financial derivatives, the most significant difficulty which arises in relation to financial conglomerates is not with regard to the new forms or levels of product specific risk created but in terms of possible loss transfer between the separate principal financial markets involved.

The need to develop appropriate supervisory systems and regulatory controls is also particularly necessary, at the present time, in light of the increasing pressures on national and international financial markets generally³ and of the recent, more specific, instances of financial collapse through poor trading and fraud.⁴ The significant global opportunities for further market

¹ This Chapter is based on G. A. Walker, "The Law of Financial Conglomerates - the Next Generation" *The International Lawyer* (Vol. 30, No. 1, 1996), p. 45; and Walker, "The Joint Forum doesn't add up" *The Financial Regulator* (Vol. 3, No. 2, 1988), p. 45.

² For a recent study of trends in international banking, securities and derivatives markets, see BIS, *International Banking and Financial Market Developments* (July 1998).

³ For general review, see authorities cited Introduction, n. 2.

⁴ In connection with the collapse of the Bank for Credit and Commerce International [BCCI] see generally, *Report into the Supervision of the Bank of Credit and Commerce International*, HMSO, London, 22 October 1992 [the Bingham Report]; and Senator John Kerry and Senator Hank Brown, *The BCCI Affair*, Report to the Committee on Foreign Relations, United States Senate, 30 September 1992. In connection with collapse of Barings,

expansion created under the interim GATS arrangements agreed in July 1995⁵ and subsequent developments in this area also make this a matter of urgent attention.

The purpose of this Chapter is to consider some of the basic issues which arise in connection with the development of conglomerate forms of business in the financial services area. Following a note of the specific supervisory and regulatory difficulties which arise with regard to the growth in financial conglomerates, the recommendations contained in the most important recent international papers will be considered. Conclusions will also be drawn with regard to the relevance and effectiveness of the response of the Basle Committee to date.

1. Conglomerate Structures

The term conglomerate can be used to refer to any form of business structure in which, at least, two distinct forms of industrial activity or service provision are involved.⁶ This usually involves groups of companies in one, or more, industrial or commercial sector, although the term may also include a single corporate entity which provides more than one distinct industrial or commercial service.⁷

Although the term can clearly be applied to industrial or commercial companies, or groups of companies, special difficulties arise with regard to financial conglomerates. A financial conglomerate is a single company or group of companies which provides, at least, two distinct forms of financial service. This includes, for example, an integrated investment house which provides a

see Bank of England, *Report of the Board of Banking Supervision Inquiry into the Circumstances of the Collapse of Barings* (18 July 1995).

⁵ Under the interim arrangements, agreed in Brussels on 26 July, but without the full support of the United States, 90% of world financial services, in more than 90 countries, was covered by the new trade liberalisation measures which were to last until the end of 1997. This market is estimated to be worth \$20,000 billion in terms of world banking assets and a further \$20,000 billion of deposits, \$10,000 billion of world stock market capitalisation, £10,000 billion of listed bonds and \$2,000 billion of world insurance premiums. For an initial report, see *Financial Times*, July 27 1995, p. 6; and World Trade Organisation, *WTO Director-General Hails Financial Services Accord* Press, Release/18, 26 July 1995.

⁶ See generally, J. Maycock, *Financial Conglomerates: The New Phenomenon* (1986); C. Spruill, *Conglomerates and the Evolution of Capitalism* (1983); H. McVea, *Financial Conglomerates and the Chinese Wall* (1993). Sir Timothy Bevan, "Banking Conglomerates: Revolution or Evolution?" (1985) Aug. *Barclays Bank Review* 56. For a United States perspective, see C. Lichtenstein, "International Standards for Consolidated Supervision of Financial Conglomerates: Controlling Systemic Risk", *Brooklyn J. Int'l L.* (Vol. XIX: 1 1993), p. 137. See also J. R. Macey, "The Inevitability of Universal Banking" 19 *Brook.J.Int'l L.*, p. 203; and H. A. Garten, "Universal Banking and Financial Stability" 19 *Brook.J.Int'l L.*, 159.

⁷ See, Maycock, *op. cit.*, n. 6, p. 2.

range of financial services through internal Chinese Walls⁸ or a group of connected financial companies with the most serious recent concerns being expressed in connection with the provision of banking, securities and insurance services from within the same group.

A mixed, or mixed-activity, conglomerate is a group of companies involved in various industrial or commercial sectors with, at least, one unit which provides financial services from one of the three principal service areas referred to.⁹

2. Conglomerate Development

The first large conglomerates in the United Kingdom and the United States emerged in the 1960s. Two of the earliest examples were Ling-Temco-Vought, in the United States, and Slater Walker, in the United Kingdom, both noted for the absence of any relationship between the various activities undertaken by their component elements and for their early collapse.¹⁰

In the United Kingdom, the growth of financial conglomerates began in the 1960s with the expansion of the range of services provided by the large deposit banks through the establishment, or acquisition, of subsidiary service companies. By the mid 1970s most deposit banks had a large number of subsidiary companies providing a wide range of financial services.¹¹ Following the deposit banks, the use of conglomerate forms of business spread to the merchant banks, discount houses,¹² savings institutions, securities houses and investment groups and, subsequently, to insurance companies.¹³

On the European continent, the development of financial conglomerates was not as spectacular since substantial market growth was possible through internal expansion, on a Swiss/German universal bank model, which involves

⁸ In connection with such single company service provision, one particular area of concern which has arisen in the United Kingdom was with regard to the abuse of trading privileges by market makers who are allowed to trade under cover on their own accounts in the United Kingdom. The Securities and Investments Board [SIB], which was then responsible for the regulation of the provision of investment services in the United Kingdom under the Financial Services Act 1986, undertook an eighteen month review into the privileges available to market makers on the London Stock Exchange following an earlier Office of Fair Trading Report. See SIB, *Equity Market Review Report*, 21 June 1995.

⁹ The specific difficulties which arise in connection with mixed conglomerates are discussed further below. See, Section 4.5.2(14) *infra*.

¹⁰ See, Maycock, *op. cit.*, n. 6, p. 2. See also, Charles Ray, *Slater Walker - An Investigation of a Financial Phenomenon* (1977).

¹¹ See, Maycock, *op. cit.*, n. 6, Ch 3.

¹² In the United Kingdom, a discount house is an agent bank of the Bank of England in the primary money market or Discount Market. See, D. Goacher, *The Monetary and Financial System* (1990), pp 67-70; P. Howells and K. Bain, *Financial Markets and Institutions* (1990), pp 94-102; and J. Gilbody, *The UK Monetary and Financial System* (1991) pp 127-131.

¹³ See, Maycock, *op. cit.*, n. 6, Ch 4.

the provision of both commercial and investment banking services from within the same corporate unit.¹⁴ Of more importance in terms of recent development, however, has been the substantial increase in the number of Bancassurance or Bancaffianz groups,¹⁵ especially in Germany and France,¹⁶ which provide both banking and insurance services from within the same group, with the banking parent or subsidiary company, or companies, usually already providing commercial and investment banking services on the universal banking model.¹⁷ Although this may only involve the sale of retail banking services with life assurance initially, corporate investment banking as well as general insurance cover may subsequently be developed subject to local regulatory restriction.¹⁸

During the 1980s and 1990s, the substantial growth of conglomerate forms of business in Europe was possible though the domestic deregulation of many markets as well as the globalisation of financial markets generally as a result of the removal of many restrictions on the free movement of capital and improvements in telecommunications facilities and computer technology.

In the United States, the early development of financial conglomerates was limited due to restraints on branch banking, imposed under the McFadden Act of 1927, and the functional separation of commercial investment banking introduced under the 1933 Glass-Steagall Act¹⁹ although considerable business expansion was subsequently possible, both nationally, through the use of

¹⁴ In regulatory terms, this has led to a distinction being drawn between institutional regulation on the European continent and functional regulation in the United Kingdom which is more concerned with the type of financial service provided rather than type of institution.

¹⁵ This is sometimes referred to as structural diffusion or structural arbitrage.

¹⁶ It was estimated that by June 1994 there were over 200 bank-assurance groups within Europe. See K. Coates and C. Finch, "A single passport for insurers - where next?", *EFSL*, June 1994, 49 at 50.

¹⁷ See generally, P. Woolfson, "'Bancassurance' and Community Law: Current Status and Expected Developments" (1994) 12 *Journal of International Business Law* 519; and N. O'Niell, "Supervision of Financial Conglomerates" (1994) *Journal of International Business Law* 235.

¹⁸ For a study into the measurement and assessment of the relative efficiency of banking and bancassurance strategies through financial ratio analysis and data envelopment analysis see, M. Brown and E. Gardener, *Bancassurance and European Banking Strategies: An Exploratory Analysis using DEA of the Concept and Treatment of 'Relative Efficiency'*, Paper presented to the Annual Conference of the European Association of University Teachers in Banking and Finance, University of Modenna, Italy, September 1994.

¹⁹ See generally, Smith, *Glass-Steagall Act, A History of Its Legislative Origins and Regulatory Construction* (1975) 92 *Banking L.J.* 38; Perkinns, *The Divorce of Commercial and Investment Banking: A History* (1971) 88 *Banking L.J.* 483; and Willis, *The Banking Act of 1933 in Operation* (1935) 35 *Colum. L. Rev.* 696. For more recent comment see generally, R. Karmel, "Glass-Steagall: Some Critical Reflections" (1980) 97 *Banking Law Journal* 631; and J.J. Norton, "Up against 'the Wall' - Glass-Steagall and the Dilemma of a Deregulated 'Regulated' Banking Environment" (1987) 42 *Business Lawyer* 327.

Financial Conglomerates

holding companies²⁰ and Section 20 subsidiaries,²¹ and overseas, for example, through the use of Edge Act Corporations subject to the Federal Reserve Board's Regulation K.²²

Despite the Hunt Commission's investigation in 1970, significant deregulation was not introduced in the United States until the 1980s, with the 1980 Depository Institutions Protection Act and the 1982 Garn-St Germain Depository Institutions Act,²³ although, even then, this was not substantial. While there have been other proposals for the abolition, or, at least revision, of the Glass-Steagall Act, and of the more penal provisions of the Bank Holding Company Act, none has yet been successful. More significant progress may, however, be possible under the proposed 1995 Financial Services Competitiveness Act.²⁴ The most recent debate in this area has focused on whether if relaxation of Glass-Steagall is to be permitted whether it should

²⁰ Under the Bank Holding Company Act 1956, provided that the activity involved could be determined to be so closely related as to be a proper incident to banking and be reasonably expected to bring public benefits in the form of greater convenience, increased competition or efficiency gains, which outweigh any possible adverse effects of undue concentration, decreased or unfair competition, conflicts of interest or unsound banking practices. See, J. Norton, *Banking Law Manual* (1995), paras 4.04, 4.07 and 5.06. Following the adoption of the Bank Holding Company Act, after a slow beginning, by 1980 361 multi-bank holding companies had been established in the United States in contrast to 2,426 one-bank holding-companies. For discussion, see Maycock, *op. cit.*, n. 6, p. 37.

²¹ See, Norton, *op. cit.*, n. 20, at para 4.04. See also, Lichtenstein, *loc. cit.*, n. 6.

²² An "Edge" corporation is a federally chartered international banking or financial corporation set up under Section 25(a) of the Federal Reserve Act of 1919 as amended, *inter alia*, by the 1978 International Banking Act. See Norton, *op. cit.*, n. 20, at paras 15.03[1] *et seq.*

²³ These measures facilitated, *inter alia*, greater equality between depository institutions and the granting of new powers to thrift institutions to compete with banks as well as the cross-border acquisition of certain institutions in difficulty.

²⁴ The Financial Services Competitiveness Act of 1995 was drafted by Congressman Jim Leach, Chairman of the House of Representatives Banking and Financial Services Committee. Under the Bill bank and securities companies are to be allowed to own each other, subject to certain protections, although banks involved with government insured deposits will have to use a holding company structure to establish effective firewalls between the banking and non-banking risks. For comment see, *Financial Times*, May 4 1995. The 1995 measure has since been replaced by the Financial Services Competitiveness Act of 1997 which will *inter alia* allow banks to affiliate with securities firms and insurance companies. See H.R. 10, 105th Cong. For comment see R. Fisher, "Banking Reform and Regulatory Relief" *Annual Review of Banking Law* (1998), Vol. 17, pp 2-8. Following heavy opposition to H.R. 10, the House Banking Committee issued a separate diluted version of the Bill. The Bill was passed by the House on 13 May by a 214-213 vote. For comment see, "Financial Modernization - Senate Faces Increasing Pressure to Consider Banking Reform Bill," *Banking Law Report, BNA* (Vol. 17, No 11, p 4). See also, "Financial Modernization - Senate Enters Financial Services Reform Debate by Holding Hearings," *Banking Law Report, BNA* (Vol. 17, No 14, p 5).

precede through the use of holding company structures as favoured by the Federal Reserve or operating subsidiaries as developed by the OCC.²⁵

Special difficulties also remain with regard to the relationship between the banking and insurance industries in the United States again despite regular calls for reform.²⁶ Ever since the reversal of *Paul v. Virginia* in 1869²⁷ by the Supreme Court in *Southern-Eastern Underwriters Association* in 1944,²⁸ and the adoption in 1945 of Public Law 15, the McCarran-Ferguson Act, the insurance industry has been subject to very strict regulation at the state level due to the threat of federal intervention in the event that such control was not considered sufficiently effective.²⁹

Banks have also been restricted from providing insurance services, other than by national banks in small communities,³⁰ while bank holding companies are prohibited from owning substantial non-bank subsidiaries, unless properly incidental to their banking business and of sufficient public benefit,³¹ although there have been some recent developments in this area which may involve the extension of bank's powers in this regard.³²

²⁵ In relation to the OCC model see J. J. Norton, "The *Glass-Steagall Act* and Related Bank Legislative Reform in the United States: Non-Legislative Bank Regulation and Modernization - The Recent Comptroller of the Currency "Op-Sub" Regulation". See also, "Op-Sub Debate Heats Up As Regulators Consider Merits of H.R. 10" *Banking Policy Law Report*, *BNA* (Vol. 17, No 12, p 5).

²⁶ The House Banking Committee, on June 28 1995, approved the controversial Baker Affiliation Amendment, by a 36-12 vote, which would allow national banks to affiliate with insurance companies in a holding company structure in states which permitted state-chartered banks to have insurance affiliates. Although Congressman Leach had attempted to exclude any extension of banks powers to engage in insurance business from being included in the Financial Services Competitiveness Act, *supra* n. 24, on June 28, concessions were accepted in connection with the moratorium on new bank insurance powers. See, Bureau of National Affairs, Inc., *Banking Report*, July 3 1995. For subsequent amendments under H.R. 10 see Fisher, *loc. cit.*, n. 15.

²⁷ *Paul v. Virginia*, 231 U.S. 495 (1869).

²⁸ *U.S. v. Southern-Eastern Underwriters Association*, 322 U.S. 533 (1944).

²⁹ Under the McCarran-Ferguson Act Congress, insisted that the regulation of the insurance industry was a matter for federal control, following the reversal of the decision in *Paul v. Virginia*, which had held that insurance was not inter-state commerce. Under the Act, however, states were allowed to continue to regulate their own industries provided they did so effectively. See, E.J. Vaughan and C.M. Elliott, *Fundamentals of Risk and Insurance* (1989)(5th edition), Ch 10.

³⁰ See, Norton, *op. cit.*, n. 20, at para 4.07

³¹ *Ibid*, para 4.07[2].

³² See, for example, *American Land Title Assn. v. Clarke*, 968 F. 2d. 150 (1992) in connection with title insurance agency business; *Independent Ins. Agents of America v. Ludwig* 302 U.S. App. D.C. 268 (1993) in connection with geographical limits on the solicitation of insurance customers; and *Nationsbank v. Variable Annuity Life Ins. Co.* 8 Fla. Law W. Fed. S 534 (1995) in connection with the sale of annuities by national banks. For comment see, D. King, "Judicial Expansion of National Banks' Insurance Powers: The Resurrection and Statutory Interpretation of Section 92 of the National Bank Act" *19 Iowa J. Corp. L.* 833; and C. Heigel, "Case Comment: Independent Insurance Agents of America,

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The restrictive nature of the prohibitive or exclusionary regulatory climate in the United States is, however, clearly in contrast with the general global development of more integrated forms of business structures involving financial and mixed conglomerates the growth of which requires urgent regulatory attention.

Before considering the recent supervisory and regulatory developments which have occurred in this area, the basic advantages and corresponding risks which arise with regard to the use of conglomerate structures of business are considered.

3. Conglomerate Advantage

Conglomerate structures have become important in terms of business strategy due to the very significant improvements possible in terms of operational efficiency and effectiveness. These benefits arise from economies of scope and scale which generate lower costs, reduced prices and improved product and service innovation. At the same time, sector synergies can substantially increase the general competitiveness of the business.

The stability of each of the structural components of a particular organisation, as well as the business as a whole, can also be significantly improved through diversified revenues and risks while product variety and innovation can increase customer loyalty and market penetration and development.

Against the perceived benefits of conglomeration, however, must be set the possible dangers of resource depletion and concentration as well new, or aggravated forms, of financial, or legal risk, which arise especially with regard to the mixing of commercial and investment banking and banking and insurance services.

4. Conglomerate Risk

Although a number of specific difficulties arise in connection with the use of conglomerate forms of business, such as with regard to management autonomy, corporate transparency and the control of conflicts of interest,³³ the most important issue which arises from a regulatory perspective is with regard to the identification and control of the additional financial exposures created through this form of business.

These exposures arise from the mixing of the traditionally separate market risks involved with banking, securities and insurance services and, more specifically, from the creation of new relationships, or dependencies, between

Inc. v. Ludwig and Variable Annuity Life Insurance Co. v. Clarke: The Banking-Insurance War in Search of a Judicial Truce" 55 Ohio St. L.J. 929.

³³ See *infra* Section 5.2.1.

these traditionally distinct categories of risk with further dangers then arising in connection with contagion and possible systemic or market collapse. It is clearly essential that any new, or aggravated, forms of risk created by the use of conglomerates, in national and international markets, are properly identified to allow appropriate corrective action to be taken.

Although the spread of financial exposure through contagion can occur in any distinct financial market, the most severe difficulties arise with regard to banks and other forms of depository and lending institutions. The basic difficulty which arises is that such institutions fund themselves short through the acceptance of retail or corporate deposits, often repayable on demand, or through short-term wholesale borrowing,³⁴ and then on-lend the re-packaged funds, to retail or corporate borrowers, on a medium to long-term basis. The effect is to create an essentially illiquid asset base in the form of a portfolio of medium to long-term loans through short-term lending.

This maturity mismatching³⁵ creates significant funding risks in the form of liquidity shortages which have to be carefully managed by the institution.³⁶ At the same time, credit exposures are created, on the asset side, in the form of possible repayment default by one or more borrowers on their outstanding commitments.

Although a certain amount of cash, or other forms of liquid asset, will always be held by any institution to cover anticipated on-going withdrawal demands,³⁷ systemic dangers arise from the possibility that unexpectedly large amounts of withdrawal requests may be made at any particular time, which liquidity shortage may be aggravated by outstanding credit defaults. Although the institution may still be technically solvent, it will not be able to meet withdrawal demands once the reserves have been exhausted, due to the fact that the largest part of the institution's asset base is held in the form of illiquid

³⁴ In the United Kingdom, this is generally effected through the parallel or secondary money markets, which comprise, the Local Authority Market, the Finance House Market, the Inter-Company Market, the Sterling Inter-Bank Market, the Sterling CD Market and the Sterling Commercial Paper Market. These markets developed in the late 1950s and 1960s following the closure of the Public Works Loan Account in 1958. The Secondary Money Markets in the United Kingdom have to be distinguished from the Primary or Discount Market in which the Bank of England acts as the United Kingdom's central bank through its agents, the Discount Houses, to adjust the volume of liquidity in the money markets on a regular basis. See generally, Goacher, *op. cit.*, n. 12; Howells and Bain, *op. cit.*, n. 12; and Gilbody, *op. cit.*, n. 12.

³⁵ This is part of the general process of maturity transformation; see generally, Howells and Bain, *op. cit.*, n. 12, Ch 1.

³⁶ This is referred to as asset and liability management.

³⁷ This is traditionally referred to as fractional reserve banking whereby a fraction of the institution's deposit base is held in reserve to cover anticipated withdrawal demands. The relevance of the phrase is now, however, less certain in light of the extensive credit facilities now available on modern inter-bank Markets. Banks accordingly no longer have to be as concerned with their basic deposit base in light of the substantial amount of wholesale short-term funding available.

loans. In such a case, the institution will have to borrow more funds from the wholesale markets although its ability to do so may be affected by a revised credit standing. Alternatively, it will have to approach the relevant central bank for additional funding through its lender of last resort operations.³⁸

The liquidity difficulties experienced by one institution may then be transferred to another either through actual default by the first institution on its inter-bank commitments or through a separate run by depositors on the second institution. The stability of the market as a whole can then be threatened as the exposure spreads to other banking institutions. In the absence of central bank support, the result of the contagion is market or systemic collapse.

In the event of a bank having to attempt to dispose of its loan portfolio, substantial losses on the nominal value of the loan book may be incurred as purchasing institutions will not be able to make the same credit assessment determinations and will therefore insist on various levels of discount.³⁹ To avoid these fire sales, regulators may attempt to secure a rescue of some form for a distressed institution, failing which outstanding claims against the bank will be dealt with under the relevant deposit guarantee or insurance scheme.⁴⁰

³⁸ In terms of lender of last resort operations, a distinction can be drawn between a central bank's general responsibilities to monitor the liquidity or amount of money in circulation in a market and its responsibility to assist an individual institution which may experience internal liquidity shortages. In connection with a institution in difficulty, the central bank will only assist in cases where the institution involved is illiquid but solvent, in terms of its total asset base, unless the collapse of the particular institution would effect the stability of the market as a whole.

Such support must, however, only be made available on a discretionary basis as, otherwise, moral hazard difficulties would arise in that banks, and, in particular, their credit managers would undertake additional risks due to the removal of the risk of financial loss, at the same time, as shareholders and depositors, and other creditors, would exercise less control over the management of the business. With regard to very large banks, this has led to the expression "to big too fail" in that due to their size it is assumed that the central would always have to support them to avoid market collapse. See generally, Humphrey, "Lender of last resort: the concept in history" 75:2 *Fed. Res. B. Richmond Econ. Rev.* 8 (March/April 1989); C. Goodhart, *Money, Information and Uncertainty* (1989), Ch 8; and D. Llewellyn, *The Regulation and Supervision of Financial Institutions*, The Gilbert Lectures on Banking (1986).

More specific moral hazard difficulties also arise with regard to deposit protection or insurance schemes in that depositors, or other creditors, may again fail to exercise any control over the activities of a particular institution since the protection scheme will always cover their losses. See n. 42 *infra*. For a more general discussion of the issues raised see, P. Downes and R. Vaez-Zadeh (ed) *The Evolving Role Central Banks*, IMF (1991), Part I - Role and Functions of Central Banks and Part III - Role of the Central Bank in Financial Crises; and R.C. Affros (ed), *Current Legal Issues Affecting Central Banks*, IMF (1992), Volumes 1 and 2.

³⁹ This creates a fire sale where there is a substantial loss on the disposal of the loan book although this may not necessarily be the case depending upon the quality of the loan book.

⁴⁰ In connection with the historical background to "Purchase and Assumption" arrangements in the United States and the difficulties which arise with regard to full cover

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Although the dangers of systemic collapse in modern financial markets are considerably limited due to the sophisticated nature of the markets and the ability of central bank authorities to monitor and adjust market liquidity, for general monetary policy and market stability purposes, a number of factors aggravate the risk of contagion and systemic collapse.⁴¹ These include the higher levels of risk undertaken by financial institutions as national and international price competition place increasing pressure on profit margins, the greater inter-dependence created between separate national and financial markets through improvements in telecommunications, deregulation and the globalisation of financial services and the increasing levels of exposure created through developments in national and international payment and settlement systems.⁴²

The use of the conglomerate structure itself also increases the risk of contagion both internally and externally. Due to the close relationships created between the distinct parts of the conglomerate, if one component experiences loss or financial difficulty, this may be more easily transferred to other parts of the group. This transfer of exposure may arise, for example, through direct intra-group loans or payment arrangements or cross-shareholdings, or simply as a result of damaged confidence being transferred by the market to other parts of the group.⁴³

deposit protection, see R. Dale, *Deposit Insurance: Policy Clash over EC and US Reforms*, London School of Economics Financial Markets Group, Special Paper Number 53 (1993). See also, D. Schoenmaker, *Home Country Deposit Insurance*, London School of Economics Financial Markets Group, Special Paper Number 43 (1992); and E. Kane, *The Gathering Crisis in Federal Deposit Insurance* (1985).

⁴¹ In connection with whether markets are inherently stable or unstable see, H.P. Minsky, "A Theory of Systemic Fragility" in E.I. Altman and A.W. Sametz (eds), *Financial Crises: Institutions and Markets in a Fragile Environment* (1978); C. Kindleberger, *Manias, Panics and Crashes: A History of Financial Crises* (1987); and E.P. Davis, *Debt, Financial Fragility and Systemic Risk* (1992).

⁴² In connection with the general systemic dangers involved in payment systems and the move towards real-time gross settlement in Europe see generally, Bank of England, "Developments in Wholesale Payment Systems" (1992) *BEQB* 449; D. Schoenmaker, *Externalities in Payment Systems: Issues for Europe*, London School of Economics Financial Markets Group, Special Paper, September 1993; B. Quinn, "The UK approach to controlling risk in large-value payment systems" (1993) 33 *BEQB* 530; and Bank of England, "The Development of a real-time gross settlement system" (1994) 34 *BEQB* 163. See also, BIS, *Large Value Funds Transfer Systems in the Group of Ten Countries*, (1992); European Commission, *Easier Cross-Border Payments: Breaking Down the Barriers*, Working Document, March 1992; Ad Hoc Working Group on EC Payment Systems, *Issues of Common Concern to EC Central Banks in the Field of Payment Systems*, European Community, September 1992; Ad Hoc Working Group on EC Payment Systems, *Payment Systems in EC Member States*, European Community, September 1992; and Borio, Claudio and Van den Beergh, "The Nature and Management of Payment System Risks", *BIS Economic papers*, (1993) No 36.

⁴³ See Section 6.2.1(1) and 6.5.2(3) *infra*.

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Of more importance, however, the risk of contagion is also created between different financial sectors as loss in one traditionally distinct market may be transferred to a separate market in which the same conglomerate is involved. The creation of the risk of market instability through loss transference within a single group is possibly the most significant danger created by the use of conglomerate forms of business.⁴⁴

In contrast with banking markets, securities markets are not subject to the same inherent dangers of systemic collapse due to the absence of maturity mismatching, in particular, as they will generally fund their trading activities through the issuance of short-term subordinated debt which may often be secured.⁴⁵ Difficulties can still arise, however, for example, where a securities house has a large portfolio of securities or number of open positions, which may be difficult to dispose of or close quickly, or through settlement system failures.⁴⁶

While banking business essentially involves the development and management of a portfolio of illiquid assets, with earnings arising from the difference in the interest rate paid to depositors and that charged to borrowers, securities business involves the underwriting and disposal, or purchase and sale, of generally liquid securities through various the primary and secondary trading markets.⁴⁷ Earnings are generated from the difference in the price a security is bought and sold at as well as in additional underwriting and other ancillary advisory or service fees. In terms of operational risks, investment houses are subject to market or position risk, that is adverse movements in the price of the

⁴⁴ See generally, R. Dale, "Regulating Investment Business in the Single Market" [1994] *BEQB* 333; and Dale, "Regulating Bank's Securities Activities: A Global Assessment" (1991) *JISM* 277, at 286. See also Dale, *Risk and Regulation in Global Securities Markets* (1996).

⁴⁵ Subordinated debt is generally treated more favourably for capital adequacy purposes in relation to securities business than banking business. Under modern capital requirements it is consequently cheaper to provide securitised funding than a traditional bank loan. For a criticism of the European developments in this area. See R. Dale, *International Banking Deregulation: The Great Banking Experiment* (1992).

⁴⁶ For a general discussion of the systemic issues involved with securities markets, see OECD, *Systemic Risks in Securities Markets*, (1991); for comment see, Lichtenstein, *op. cit.*, n. 6, p. 140. See also, R. Fogel, "Stability of Financial Markets: Federal Reserve Responsibility?" in Downes and Vaez-Zadeh, *op. cit.*, n. 37, Volume 1, Ch 15, p 317. See also, B. Longstreth, "Averting a Chain Reaction Disaster in the Money World" *Bus. & Soc'y Rev.*, Summer 1983, 32; and Dale, *loc. cit.*, n. 44. In connection with clearance and settlement difficulties in securities markets see generally, Group of Thirty [hereinafter G 30], *Clearance and Settlement Systems in the World's Securities Markets* (March 1989); and BIS, *Delivery versus Payment in Securities Settlement Systems* (1992).

⁴⁷ In securities terms, a primary market refers to the market of issuance, or placement, while the secondary market refers to the market on which the securities are subsequently traded.

security,⁴⁸ which may be linked to currency or interest rate movements, as well as counterparty or settlement risk, where dealings are carried out on a formal market.⁴⁹

In the event of a liquidity shortage, however, a securities house can either borrow more, for example, through the issuance of additional short-term subordinated debt, although then possibly only at a higher rate, or through the disposal of assets. As the assets will largely comprise tradable securities only limited loss should be incurred on their sale in contrast with the fire sale of a bank's loan book. Even in the event of a serious shortfall arising, with the segregation of client cash and securities, the firm should be able to wind up its business through the disposal of its whole portfolio with losses being limited, in the absence of fraud, and, then, generally only borne by the company's shareholders.

Distinct difficulties again, however, arise with regard to insurance business. In this case, the basic regulatory concern is not with regard to credit default by medium to long-term borrowers or by adverse fluctuations in market prices, but with the long-term stability of the invested fund to ensure that all on-going payment commitments can be made.⁵⁰ Although income generation is dependent on the value of the investment portfolio, which is subject to a certain amount of market risk, the same degree of risk does not arise as with securities businesses due to the highly regulated nature of industry which will, in particular, include composition rules to ensure that the bulk of the portfolio is made up of relatively safe assets, such as local government⁵¹ or other fixed interest debt, which provides a more stable, but not as high yielding, return.⁵²

In terms of regulatory practice, insurance undertakings are also required to maintain a sufficient level of technical reserves to cover all outstanding underwriting commitments as well as separate solvency margins to cover short-term fluctuations in asset values and trading losses. Local asset matching

⁴⁸ Adverse currency or interest rate exposure is separately assessed for modern capital adequacy purposes. See, A. Murray-Jones and A. Gamble, *Managing Capital Adequacy: A handbook of international regulations* (1991), Ch 9.

⁴⁹ . . . The risk is that a counterparty may fail to deliver title or make payment on settlement of an earlier exchange contract, for example, dealings on the London Stock Exchange were settled after five days.

⁵⁰ One specific difficulty which does, however, arise in connection with insurance regulation is the need to deal with the long-term information asymmetries which arise in monitoring the value of the fund and with the need to secure proper contract performance at the end of the investment period.

⁵¹ An important aspect of insurance and banking market regulation historically has been its use by central banks to develop domestic monetary policies through regulatory controls and, for example, with regard to the maintenance of a sound market in local government debt.

⁵² For a comprehensive treatment of national insurance systems and the Transnational issues which arise, see D. Campbell (ed), *International Insurance Law and Regulation* (1994).

requirements may also be imposed to ensure that particular branch or overseas operations have sufficient realisable assets to cover local payment demands.

The justification for the imposition of reserves and solvency requirements, in addition to composition rules, is that insurance companies may not otherwise hold appropriate or sufficient levels of assets to cover commitments. Although premia are paid in advance by policy-holders, performance under the contract will not be required until a specified future date or only in the event of a certain stated contingency arising. The purpose of insurance regulation is accordingly to protect the value of the fund against dilution, for example, through competition in premia pricing or the failure to maintain sufficient asset cover, so that all required contractual payments can be made by the regulated undertaking.⁵³

In light of the very basic differences which exist between the principal financial services markets, although securities and insurance markets are subject to significant but distinct operational risks, they are not inherently subject to the same dangers of systemic collapse, as banking markets, due to the absence of maturity mismatches. The very serious danger which remains with regard to the use of conglomerate forms of business, however, is that trading losses incurred on securities markets may be easily transferred to the banking markets with the significant destabilising effects which that could have on national and international markets generally.⁵⁴ Substantial securities losses could, in particular, arise from trading on more speculative or volatile foreign currency and derivatives markets.⁵⁵

The danger of loss transfer may be particularly acute where, for example, bank deposits have been used to support securities losses for a period before the collapse, as in the case of Barings, or the availability of public support for the banking operations has created serious moral hazard difficulties in the management of the securities business.

A similar difficulty may, of course, arise where losses are transferred to the insurance markets which may have a detrimental effect on the solvency of a

⁵³ See generally, J. Finsinger and M. Pauly, *The Economics of Insurance Regulation: A Cross-National Study* (1986); and E.J. Vaughan and C.M. Elliott, *op. cit.*, n. 29, at Ch 10.

⁵⁴ See n. 37 *supra*.

⁵⁵ In connection with the regulatory difficulties which arise with regard to modern derivatives trading, see generally, Basle Committee, "The Management of Banks' Off-balance Sheet Exposure: A Supervisory Perspective" (March 1986); BIS, *Recent Innovations in International Banking* (April 1986) ("the Cross Report"); BIS, *Recent Developments in International Interbank Relations* (October 1992) ("the Promisel Report"); G 30, *Report on Derivatives* (July 1993); Bank of England, *Derivatives: Report of an Internal Working Group* (April 1993); Basle Committee, *Prudential Supervision of Banks' Derivatives Activities* (December 1994); and Joint report by the Basle Committee and the Technical Committee of the International Organisation of Securities Commission [IOSCO], *Framework for Supervisory Information about the Derivatives Activities of Banks and Securities Firms* (May 1995).

particular fund, or funds, with the consequential long-term social and welfare damage which that may cause.

5. Structural Regulation

One solution to the difficulties created by the risk of loss transfer between separate financial markets is through the use of separation rules or structural regulation at the authorisation stage. In terms of separation options, the most extreme form available is the Glass-Steagall model which has been developed in the United States⁵⁶ and Japan.⁵⁷ This involves the prohibition on banks from undertaking securities business or from owning securities firms. Intermediate options include the use of financial holding companies or separately capitalised securities subsidiaries with appropriate financial firewalls to prevent risk transfer.⁵⁸

This extreme but pure form of risk or loss separation has also been followed in Japan since the Second World War and the imposition of the United States rules on the Japanese financial industry as part of the reconstruction operations.

At the other regulatory extreme is the universal bank model which allows banks to engage fully in banking and securities activities.⁵⁹ To deal with the additional exposure created in this case, capital adjustment mechanisms can be used to ensure that sufficient capital is available to cover all of the risks involved. In this case, however, the capital mechanisms act by way of loss absorption rather than through the restriction on loss transfer.

In Europe, risk separation in connection with commercial and investment banking is dealt with by distinguishing a bank's loan book from its securities, or trading, book in connection with which separate capital requirements are imposed.⁶⁰ This is extended to the group level by requiring that consolidated accounts are prepared in respect of all banking and investment groups in connection with which further capital adjustments are imposed to prevent abuse, such as, through deduction of interests in other financial companies in the calculation of adequate own funds which prevents double-gearing.⁶¹

⁵⁶ For a critical analysis of effectiveness of the Glass-Steagall system see, Dale, *loc. cit.*, n. 44.

⁵⁷ See generally, M.J.B. Hall, *Banking Regulation and Supervision: A Comparative Study of the UK, USA and Japan* (1993); and R. Dale, "Japan's 'Glass-Steagall' Act" *Journal of International Banking Law*, 1987, Vol 3, pp 138-146.

⁵⁸ See n. 20 and 21 *supra*.

⁵⁹ See Section 2 *infra*.

⁶⁰ Under Council Directive 93/6/EEC on the capital adequacy of investment firms and credit institutions of 15 March 1993 (OJ L 141, 11.6.1993, p. 1).

⁶¹ Under Council Directive 89/299/EEC on the own funds of credit institutions of 17 April 1989 (OJ L 124, 5.5.1989, p. 16) as amended by Directive 91/633/EEC of 3 December 1991 (OJ L 339, 11.12.1991, p. 33) and Directive 92/16/EEC of 16 March 1992 (OJ L 75,

In connection with insurance regulation, although structural regulation is also generally imposed on insurance companies at the authorisation stage, to prohibit them from undertaking any other substantial types of business, this may not be extended to include restrictions on controlling interests or subsidiary operations.

One particular example of structural regulation in the insurance industry, is the prohibition on composite insurance, which involves the provision of life and non-life cover by the same company although any difficulties which may arise can be dealt with through the maintenance of separate accounts and solvency margins.⁶² Another more specific example, is the restriction of cumul which arises where an insurer can either cover a particular risk through a place of establishment in a particular country or on a cross-border basis from another.⁶³

In light of the different global approaches adopted with regard to structural regulation and of the very distinct treatment of risk in each of the separate financial markets involved, considerable difficulties will arise in attempting to develop common rules or guidelines for the supervision of financial conglomerates at the international level. Each of the very distinct sets of national law and supporting regulatory practice will have to be examined in an attempt to arrive at some common agreement on the relevant requirements.

Where it is not possible to agree particular sets of provisions on specific matters, in light of the very basic differences which arise with regard to market structure and national practice, a mixture of harmonised rules and supervisory or regulatory options will have to be developed which are capable of general acceptance and which can secure a sufficient degree of equivalence in terms of risk identification and protection.

6. The International Response

The main work produced, to date, in connection with the development of global responses to the difficulties created by the supervision and regulation of conglomerates has been undertaken by the Basle Committee⁶⁴ and by IOSCO.⁶⁵

21.3.1992, p. 48); and Council Directive 89/647/EEC on a solvency ratio for credit institutions of 18 December 1989 (OJ L 386, 30.12.1989, p. 14) as amended by Directive 91/31/EEC (OJ L 17, 23.1.1991, p. 20).

⁶² In Europe the establishment of new composites was prohibited under the early Life Insurance Directives although these restrictions were subsequently removed following an investigation by the European Commission into the relative performance of composite insurers and those providing life business only. See, N. Paul and R. Croly, *EC Insurance Law*, Cameron Markby Hewitt, (1991), para 7.19.

⁶³ See, Paul and Croly, *ibid*, paras 4.19-4.22.

⁶⁴ See n. 55 *supra*; and generally, C.J. Thomson, "The Basle Concordat: International Collaboration in Banking Supervision" in R.C. Affros (ed), *op. cit.*, n. 37, Vol 1, Ch 126, p.

Although the Basle Committee has been developing general principles for the supervision of international financial institutions and financial groups on a consolidated basis,⁶⁶ and convergence standards in respect of bank capital,⁶⁷ since its establishment in 1974, the Committee has also been concerned with the specific difficulties created by the development of financial and mixed-activity conglomerates.⁶⁸ In light of these difficulties, the Committee set up a multi-disciplinary working group, made up of regulators from each of the three principal supervisory areas involved, to examine the feasibility of developing general principles for the supervision of financial conglomerates.⁶⁹ This working group subsequently became known as the Tripartite Group of Banking, Insurance and Securities Regulators and in February 1996 was formally re-constituted as the Joint Forum.

In connection with this work, the Basle Committee set out a series of general principles for the supervision of financial conglomerates for examination by the working group which principles were reprinted in its 1992

331; and C. Freeland, "The Work of the Basle Committee" in R.C. Affros (ed), *op. cit.*, n. 38, Vol 2, Ch 19, p. 231.

⁶⁵ See n. 55 *supra*; and Technical Committee's Report, *Principles for the Supervision of Financial Conglomerates*, International Organisation of Securities Commissions, IOSCO Doc 7, 1992. The Report was presented at the 17th Annual Conference in London in October 1992.

⁶⁶ The Basle Committee's early recommendations with regard to the development of effective supervisory techniques in connection with the overseas activities of international banks, and, in particular, with the allocation of appropriate supervisory responsibilities were set out in the First Concordat in 1975; see Basle Committee, "Report to the Governors on the Supervision of Bank's Foreign Establishments" (September 1975). A Revised Concordat was subsequently issued in 1983 following an earlier paper in October 1978 recommending that supervision be conducted on the basis of the consolidated balance sheet of all an international bank's constituent entities; see Basle Committee, "Principles for the Supervision of Banks' Foreign Establishments (May 1983) and Basle Committee, Consolidation of Banks' Balance Sheets: Aggregation of Risk-Bearing Assets as a Method of Supervisory Bank Solvency" (October 1978). A supplement to the Revised Concordat was then issued in 1990; see Basle Committee, "Report on International Developments in Banking Supervision" (September 1990). This was followed by a restatement of the Minimum Standards for Supervision in 1992; see Basle Committee, "Report on International Developments in Banking Supervision" (September 1992), Ch VI. A collection of confidential responses from national supervisors to questionnaires issued by the Committee was also prepared in 1984, although this was not subsequently made available to the general public. See Chapter 2, Section 1.

⁶⁷ See Basle Committee, "Report on International Convergence of Capital, Measurement and Capital Standards" (June 1988).

⁶⁸ See Sections 6.III and IV *infra*.

⁶⁹ Although the work was to be carried out by the special multi-disciplinary working group set up by the Basle Committee, the group would have access to the work being carried out on the subject by such other international institutions as IOSCO and in the European Community; Basle Committee, "Report on International Banking Supervision" (September 1992), at p.59.

Report on International Developments in Banking Supervision.⁷⁰ One month after the Basle Committee published its general principles in September 1992, IOSCO issued its Report on the Supervision of Conglomerates.⁷¹

The Tripartite Group subsequently issued a progress report in 1994⁷² and a final Report was published in July 1995.⁷³ Since its establishment the Joint Forum has produced a confidential Interim Report for the G10 Governors with a separate Progress Report being issued in April 1997 in advance of the Denver G7 Summit.⁷⁴ A number of consultation documents were also issued in February 1998.⁷⁵

The principal conclusions and recommendations of each of these Reports are outlined below.

I. Basle Committee - Principles for the Supervision of Financial Conglomerates, September 1992

The basic rules with regard to the supervision of international banks and international banking groups, which will include the component parts of any financial or mixed conglomerate, are presently set out in the Basle Minimum Standards for the Supervision of International Banking Groups and their Cross-Border Establishments.⁷⁶ The Minimum Standards followed a review of international supervisory co-ordination undertaken in the summer of 1992 which was conducted after the collapse of BCCI⁷⁷ and other developments such as the events in the Atlanta branch of the Banca Nazionale del Lavoro.⁷⁸ Although the Committee concluded that the revised 1983 Concordat,⁷⁹ and the

⁷⁰ Basle Committee, "Report on International Banking Supervision" (September 1992), Ch III.

⁷¹ IOSCO Technical Committee, *Principles for the Supervision of Financial Conglomerates*, *op. cit.*, n. 64. See Section 6.II *infra*.

⁷² See Section 6.III *infra*. The Interim Report is reprinted in the Basle Committee, "Report on International Banking Supervision" (September 1992), *op. cit.*, n. 66, Ch VII.

⁷³ See Section 6.IV *infra*.

⁷⁴ See Progress Report by the Joint Forum on Financial Conglomerates, 9 April 1997. See also correspondence from Dr. T Padoa-Schioppa, Chairman of the Basle Committee, A. Neoh, Chairman of the Technical Committee of IOSCO and Mr G. Pooley, Chairman of the IAIS to Mr R. E. Rubin, Secretary of the United States Treasury, April 1997. See Sub-section V. *infra*.

⁷⁵ See Sub-section VI. *infra*.

⁷⁶ Basle Committee, "Minimum Standards for the Supervision of International Banking Groups and their cross-border establishments" (Summer 1992), reprinted in Basle Committee, "Report on International Developments in Banking Supervision" (September 1992), n. 66 *supra*, Ch III.

⁷⁷ See n. 66 *supra*. See also, n. 4.

⁷⁸ Basle Committee, "Report on International Developments in Banking Supervision" (September 1992), *op. cit.*, n. 65, at p. 10. See Chapter 2, Sub-section 1.IV.

⁷⁹ See n. 66 *supra*.

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1990 Supplement,⁸⁰ were soundly based, it was concerned that supervisory authorities had to strengthen their commitment to implement the best-efforts character of the principles established.⁸¹ The Committee accordingly recommended that certain minimum standards for supervision were established, and that all Group of Ten authorities should be expected to observe them, at the same time, as undertake to urge other supervisory authorities throughout the world to adhere to the new minimum standards set.⁸²

Separate general principles for the supervision of financial conglomerates were also included in the 1992 Report on International Banking Supervision, the stated purpose of which was to set out certain principles which the main supervisors of financial institutions in the Group of Ten countries believed should govern the supervision of international groups which include business activities subject to more than one supervisory authority with the specific emphasis of the paper being concerned with the prudential conduct and soundness of such groups.⁸³

Although the principles developed were not necessarily to be given specific legal or regulatory effect in the countries involved, they were recommended as principles of general practice which authorities should follow to the extent that they were able. Where this was not possible, authorities were expected to modify their arrangements to enable adherence with the relevant principles. Where situations arose not covered by the principles stated in the paper, the authorities concerned were required to consult with each other to agree a basis to secure the adequate supervision of the institutions involved.⁸⁴

The principles were generally concerned with financial conglomerates, although it is stated that they could be equally applied to the supervision of mixed conglomerates comprising any group of companies whose activities largely consisted of providing financial services in different sectors, but which may also have some commercial or industrial interests.

Although drawn up to deal with the difficulties created by groups subject to supervision in more than one country, the principles were equally applicable to groups carrying on business in a single state.

The Report lists a number of specific difficulties which arise in connection with the supervision of financial conglomerates and sets out a corresponding set of general principles of supervision with some additional notes on the methods of supervision.

⁸⁰ See n. 66 *supra*.

⁸¹ *Ibid*, p. 10.

⁸² See Chapter 3, Section I.IV. The detailed requirements of each of the Minimum Standards are expanded in the text. See Basle Committee, "Report on International Developments in Banking Supervision" (September 1992), *op. cit.*, n. 66, pp 11-18.

⁸³ *Ibid*, p. 59.

⁸⁴ *Ibid*, p. 60.

(a) Conglomerate Supervision Difficulties

Although the advantages of asset, risk and sources of earnings diversification of conglomerate structures are recognised, it is noted that a number of additional supervisory difficulties are created with their use.⁸⁵

(i) Contagion

Capital shortages and confidence damage may be caused in parts of the group through activities of supervised or unsupervised entities in other parts

(ii) Double-Gearing

The sum of the regulated component capital requirements may not be covered by the total group capital through double-gearing while capital weaknesses may be created through quality dilution, for example, the downstreaming of subordinated debt through equity participations.

(iii) Risk Mixing

Management and control procedures may be of insufficient quality to meet the demands of the more complex risk management necessary to obtain the advantages of the services synergy available with the conglomerate structure. Management weaknesses may, in particular, result in the continuation of losses in one part of the group subsidised by profits elsewhere.

(iv)* Intra-Group Exposures

Contagion difficulties are significantly exacerbated through complex intra-group exposures which may create a web of direct and indirect claims, for example, through credit lines, equity investments, trading exposures, liquidity management, guarantees and commodities.

(v) Conflicts of Interest

Serious conflicts of interest may arise when a banking group acts for customers in different capacities through the provision of a range of different services, and where substantial investors in the group or its affiliates are also customers of the group in one capacity or another. Although the difficulties created can be dealt with by Chinese Walls, it is noted that these may not

⁸⁵ *Ibid*, pp 61-63.

prevent the reputation of the group as a whole suffering damage and that they may break down if put under any pressure.

(vi) Management Authority

Although the benefits of conglomeration require central management, supervisors of the component parts of the operation must be satisfied that adequate management is exercised at the regulated level.

(vii) Dispersion of Control

Loosely structured conglomerates may result in the decentralisation of control which obstructs effective supervision as well as possibly accentuating conflicts of interest problems.

(viii) Transparency

Conglomerate structures must be transparent to ensure that the totality of risk involved can be properly assessed, although increasing difficulties arise through the separation of the legal structure from the business structure for tax and regulatory purposes.

(b) Principles of Supervision

Although it is noted that the structures of financial conglomerates are extremely varied, and continuously changing, an attempt is made to establish certain general principles which can be developed for application in each individual case.⁸⁶

(i) Ambit of Supervision

Supervision should be carried out on a group-wide basis from the top down where the conglomerate is headed by a supervised institution or a financial holding company on the United States bank holding company model. Where the parent company is not supervised, any parallel financial companies must be treated on a group-wide basis with the supervisor, in all cases, ensuring that all risks are adequately assessed.

Where a group includes substantial non-financial activities, supervisors should ensure an extra measure of prudence within the supervised institutions

⁸⁶

Ibid, pp 63-67.

although where these interests are material it is recognised that supervisors can do little to prevent the possible risk of contagion.⁸⁷

(ii) Information and Consolidation

Supervisors should have access to information about the complete range of risks carried on by each of the financial components in the group. Although this information is most easily available from the parent holding company, if access to the parent company is not possible the information must be obtained from the supervised entity.

Some form of consolidated supervision should be effected by the supervisor responsible for the parent company or the major operating entity, although a more qualitative assessment of the group should be effected beyond a simple accounting consolidation which may distort the true level of risk present due to the different accounting principles applicable to the separate activities involved. As the distinctions between different types of financial intermediation break down, it is necessary that a more qualitative based assessment is undertaken to ensure that all risks present in the group are taken into account.

(iii) Capital Strength

The capital base of the parent company within a group should be at least as large as the sum of the capital required by the supervisors and regulators of each of the operating companies involved, with the capital employed in any unregulated subsidiaries, in cases both where the parent is a substantial financial institution and where it is only a holding company with the operations of the group being undertaken by subsidiaries.

The quality of the parent company's capital should also be as good or better, although some minor dilution may be acceptable provided this is only equal to a small proportion of total group capital.

Capital must also be well distributed within the group, with each operating company being adequately capitalised in accordance with the relevant regulatory provisions, although the group structure must not allow the same capital to be used more than once.⁸⁸

⁸⁷ Difficulties arise with regard to mixed-activity groups as only authorised institutions can be supervised and sanctioned while any attempt by supervisors to exercise any authority over the non-financial element creates the risk of moral hazard to the extent that the public may assume that the whole group is subject to complete supervision.

⁸⁸ The difficulties which arise in connection with capital adequacy in conglomerates are considered in much greater detail by the Tripartite Group of Banking, Securities and Insurance Regulators final Report in July 1995. See Sub-section 6.IV *infra*.

(iv) Organisation

The structure of the conglomerate must be coherent and transparent to supervisors and regulators, as well as creditors and other customers, with supervisors having powers to prohibit obstructive corporate structures and direct the location of the place of business of the parent company and principal operating subsidiaries.

If the conglomerate includes commercial, industrial or other activities unrelated to the supervised activity, it is recommended that the financial activities are placed in a self-contained sub-group to facilitate supervision on a consolidated basis.

(v) Ownership

The fitness and properness of shareholders should be vetted to prevent conflicts arising between the interests of shareholders and other creditors, such as investors, depositors and policy-holders. Although shareholders will be concerned to ensure that their capital is properly rewarded, they must also act responsibly with regard to other group creditors.

(vi) Risk Control

Adequate control mechanisms must be in place throughout the group, and information accurately processed to ensure that all group risks are properly monitored, especially with regard to large credit and market risk exposures. Adequate arrangements must also exist to monitor and control liquidity on a group basis.

(vii) Connected Transactions

Intra-group credit lines⁸⁹ and other forms of connected payments must be carefully monitored, such as abnormal service fees or dividend payments, to ensure that regulated entities are not “milked” by non-financial members of the group.

Although consolidation is effective in assessing external risks, it is noted that it may conceal dangerous intra-group imbalances. Supervisors must accordingly carefully monitor unusual intra-group transactions as well as all forms of connected lending.

⁸⁹ For example, a banking subsidiary may lend to a non-bank parent or an unsupervised entity without normal credit assessment procedures being complied with.

(viii) Management

Supervisors and regulators must ensure that regulated and non-regulated holding companies have adequate strength of management to ensure that total group risk is prudently managed. All managers directly or indirectly capable of influencing the supervised components within the group must be qualified as fit and proper and have adequate authority to respond to the demands of supervisors acting on behalf of depositors, investors and policy-holders.

(ix) External Audit

While it is recognised that the appointment of a single audit firm may ensure that an independent overall view of the group is obtained, a local auditor with specialised knowledge of individual group activities may also have an important role to play in the supervisory process.

(c) Methods of Supervision

Although distinct methods of supervision will be adopted to give effect to the principles set out above in a particular case, these should normally include each of the following:

(i) Co-operation

Authorities must co-operate to ensure the effective supervision of groups made up of distinct entities subject to supervisors and regulators from more than one discipline and in more than one country. For this reason, authorities must have adequate powers to share prudential information, in particular, with regards to intra-group exposures.⁹⁰

(ii) Lead Supervisors or Regulators

Where possible, a convenor should be appointed to ensure that all authorities are properly furnished with all appropriate information. The convenor should usually be the supervisor of the dominant business within the group.

⁹⁰ See Basle Committee, "Information flows between supervisory authorities" (April 1990), *op. cit.*, n. 66, circulated to banking, securities and insurance supervisory authorities world-wide.

(iii) Individual Supervisor

While it is recommended that one supervisory authority should exercise overall responsibility for the whole group, where the parent company is a supervised entity, it is recognised that the other supervisors involved may not be able to surrender their functions in all cases, and may need to retain separate responsibility in connection with the activities of the group component within their jurisdiction. Insofar as possible, supervisory action should, however, be taken in co-operation with the other authorities involved.

II. IOSCO Technical Committee -
Principles for the Supervision of Financial Conglomerates,
November 1992

The Technical Committee of IOSCO issued its Report of the Principles for the Supervision of Financial Conglomerates at the 17th Annual Conference of IOSCO in London in October 1992.

The purpose of the Report was to establish general principles to form the basis for the risk assessment of financial conglomerates which could be used, as far as possible, to guide the development of regulatory practice and regulatory co-operation in the area.⁹¹ The Technical Committee, however, notes that although the principles are of relevance to the question of conglomerate supervision generally, the main concern of the Committee was with groups where securities business played a significant part.⁹²

The principal recommendations of the Technical Committee were as follows:

- (1) Risk assessment should be group based if the regulated firm that is part of the financial conglomerate is vulnerable to the risk of contagion,⁹³
- (2) Amounts counted towards regulatory capital should be controlled by appropriate regulations including, in particular, appropriate deductions to avoid double-gearing,⁹⁴

⁹¹ See IOSCO Principles, *op. cit.*, n. 65, p.10.

⁹² *Ibid*, p.3.

⁹³ *Ibid*, p.11. The effect of this is to support the traditional approach of securities regulators to the prudential regulation of securities firms on a solo as opposed to consolidated basis, although this is to be complemented through an assessment of the risk which the rest of the financial conglomerate poses for the regulated securities firm. The Introduction to the Principles notes that even where the failure of a regulated securities firm is unlikely to have serious consequences for the securities industry and the financial system generally, the risk of contagion means that it is highly desirable for the securities regulator to have early warning of problems elsewhere in the group; IOSCO Principles, at p.8. For comment on the extent to which this supports the SEC's Temporary Risk Assessment Rules under the Market Reform Act in place of the BHCA approach, see Lichtenstein, *op. cit.*, n. 6, p.155.

⁹⁴ *Ibid*, p. 17.

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- (3) The effective risk assessment of financial conglomerates requires careful monitoring of intra-group exposures and, where necessary, limits on such exposures in the regulated entity;⁹⁵
- (4) Corporate and managerial structures of the financial conglomerate should be fully understood by the regulator;⁹⁶
- (5) Regulators should seek, insofar as possible, to identify shareholders with such a stake in the conglomerate as would enable them to exert material influence;⁹⁷
- (6) Appropriate regulatory standards where managers of a regulated entity should be established;⁹⁸
- (7) Every effort should be made to promote supervisory co-operation as well as the appointment of a lead regulator where the activities of a group involve more than one regulatory authority;⁹⁹ and
- (8) Regulators should recognise the importance of the role of external auditors and the possible contribution which they may make to group-based risk assessment.¹⁰⁰

Although more limited in scope and content than the Basle Principles for the Supervision of Financial Conglomerates, the IOSCO Principles reflect the general content of a number of the Basle proposals. It is significant, however, that the IOSCO recommendations support the continuation of a solo, rather than consolidated approach, to supervision which reflects the North American style of securities supervision.¹⁰¹

III. Tripartite Group of Banking, Insurance and Securities Regulators - Progress Report on the Supervision of Financial Conglomerates, April 1994

Following the issuance of the 1992 Basle Report,¹⁰² the Tripartite Group of Banking, Insurance and Securities Regulators met for the first time in February 1993.¹⁰³ A progress report was produced in April 1994 which was sent to the Basle Committee, IOSCO and to the heads of insurance supervisory

⁹⁵ *Ibid*, p. 20.

⁹⁶ *Ibid*, p. 21.

⁹⁷ *Ibid*, p. 22.

⁹⁸ *Ibid*, p. 23.

⁹⁹ *Ibid*, p. 24.

¹⁰⁰ *Ibid*, p. 28.

¹⁰¹ See Sub-section 6.IV.2 *infra*. Additional difficulties arise in connection with this with regard to the inclusion of insurance in addition to commercial and investment banking supervision in the considerations of the Tripartite Group.

¹⁰² See Sub-section 6.I and n. 66 *supra*.

¹⁰³ The Group was chaired by a Mr Tom de Swann, Executive Director of De Nederlandsche Bank. Further meetings were held in 1993, April 1994 and November 1994.

authorities in the G10 countries¹⁰⁴ A technical sub-group was also set up to examine in further detail issues related to the overall assessment of capital adequacy in financial conglomerates although the results of this examination were not made publicly available.¹⁰⁵

In its Progress Report of April 1994, the Group made a number of recommendations with regard to supervisory approaches, co-operation, capital adequacy, structure, ownership and management, contagion, external auditors and supervisory arbitrage.¹⁰⁶

Although the Group did not wish to underestimate the difficulties which arose with regard to financial conglomerates especially in connection with the more technical aspects of prudential supervision, the Group believed that there was a realistic prospect for developing some form of multi-disciplinary understanding on the principles which would form the basis of future supervision of financial conglomerates.

IV. Tripartite Group of Banking, Insurance and Securities Regulators - Report on the Supervision of Financial Conglomerates, July 1995

As a result of the further work undertaken by the Group, a final Report on the Supervision of Financial Conglomerates was published in July 1995.¹⁰⁷ The stated purpose of the Report was to identify problems which financial conglomerates posed for supervisors and to consider ways in which these problems might be overcome.

The Report was, however, only issued as a discussion document in light of the informal nature of the Tripartite Group. A more formal Joint Forum was subsequently established by the Basle Committee, IOSCO and the International Association of Insurance Supervisors (IAIS) to develop practical working arrangements between the different supervisors involved.¹⁰⁸

¹⁰⁴ A copy of the Report is reprinted in Basle Committee, "Report on International Developments in Banking Supervision" (September 1994), Ch VI.

¹⁰⁵ The sub-group was chaired by Mr Jonathan Spencer, head of the Insurance Division of the Department of Trade and Industry in the United Kingdom.

¹⁰⁶ Basle Committee, "Report on International Developments in Banking Supervision" (September 1992), *op. cit.*, n. 104, pp 56-61.

¹⁰⁷ Copies of the Report were sent to the Basle Committee, the Technical Committee of IOSCO and the International Association of Insurance Supervisors (IAIS) early in 1995. Although the contents of the Report have not been endorsed by the three groups, the recommendations of the Report have been accepted as a sound basis for further collaborative efforts.

¹⁰⁸ The new group would propose improvements in co-operation and information exchanges between supervisors and develop principles upon which the future supervision of financial conglomerates could be based. The new group would also continue under the present Chairmanship of the Tripartite Group, Mr Tom de Swann.

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The final Report contains a number of detailed recommendations in connection with capital adequacy, supervisory co-operation and group structures as well as such other matters as contagion, large exposures, shareholders and managers' fit and properness, information access, supervisory arbitrage and mixed conglomerates.¹⁰⁹

The specific difficulties which arise with regard to capital adequacy are also considered in further detail¹¹⁰ with a number of practical examples provided.¹¹¹ An analysis of the responses received from members of the Group to a questionnaire on the present arrangements for the supervision of financial conglomerates in each of the countries and regulatory areas involved is also provided.¹¹²

(a) Financial Conglomerates and Conglomerate Structure

In its Report, the Tripartite Group agreed that the term financial conglomerate would be used to refer to any group of companies under common control whose exclusive or predominant activities consisted of providing services in at least two different financial sectors, namely, banking, securities and insurance.¹¹³ Although it was recognised that many of the problems which arose with regard to financial conglomerates would also affect mixed conglomerates offering non-financial or commercial services in addition to at least one financial service, the primary focus of the Report was on financial conglomerates.

(b) Supervisory Issues

The Report proceeds by identifying a number of specific supervisory issues in connection with which a number of supervisory recommendations are made:

(i) Overall Approach to Supervision

The Report again repeats the point that the growth of financial conglomerates made it essential that supervisors in the banking, securities and insurance sectors establish co-ordinated approaches to the supervision of the relevant institutions which supervision could not be effected on a purely solo basis.

¹⁰⁹ See Sub-section 6.IV.2 *infra*.

¹¹⁰ *Ibid*, Ch IV.

¹¹¹ *Ibid*, Appendix III

¹¹² *Ibid*, Appendix II.

¹¹³ Basle Committee, "Report on International Developments in Banking Supervision" (September 1994), *op. cit.*, n. 104, p 53.

While solo supervision of individually regulated companies should continue to be the basis of effective supervision, a group-wide perspective had to be developed in connection with the prudential assessment of the group as a whole, to ensure that supervisors could properly assess total group risks and respective capital coverage as well as limit excessive or double gearing.¹¹⁴

(ii) Assessment of Capital Adequacy

Fundamental difficulties did, however, arise in connection with capital adequacy determinations in light of the distinct prudential requirements applicable to banks, insurance and securities undertakings.

An assessment of risk from a group perspective could, however, be achieved in one of two ways.

(a) *Consolidated Supervision* - The assets and liabilities of all companies within the group are totaled and set against the parent company's capital.¹¹⁵

(b) *Solo-Plus Supervision* - Individual institutions are supervised on a solo basis according to the relevant capital requirements of their respective regulators, although this is complemented by a group-wide assessment of the availability of capital which may be achieved either through aggregation, which involved totaling the solo capital requirements of the companies within the group and comparing the result with group capital, or risk-based deduction, which involves deducting investment by parent companies in subsidiaries and any capital shortfalls in the subsidiaries from the parent's capital, with the result being compared with the parent's solo capital requirement.¹¹⁶

In its earlier progress Report, although the Group unanimously recommended that capital adequacy had to be assessed on a group wide basis, to prevent double gearing through the use of the same capital within separate parts of the group for regulatory purposes, there was no agreement on whether this should be achieved on a solo-plus or consolidated basis.¹¹⁷

¹¹⁴ *Ibid*, para 42.

¹¹⁵ Due to the emphasis on the parent or holding company, this is sometimes referred to as 'top-down' supervision.

¹¹⁶ As the emphasis is on individual supervision, this is also referred to as 'bottom-up' supervision.

¹¹⁷ Although bank regulators and securities regulators within Europe increasingly rely on consolidated supervision with possibly no solo supervision being undertaken at all, most insurance regulators and certain securities regulators, for example, in the United States, prefer solo-plus supervision due to the perceived disadvantages involved in consolidation, namely, additional costs, the possibility of supervisory involvement in non-financial activities and the combination of distinct balance sheets to which different prudential requirements are applied.

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Some members of the Group advocated undertaking further research to attempt to achieve, at least, partial harmonisation of relevant prudential rules to permit consolidation of the separate financial areas involved. Others favoured the continuation of a solo-plus approach in light of the complex and labour intensive nature of consolidation, its dependence upon the quality and consistency of the underlying accounts, which may be inaccurate or misleading, and the basic uncertainty which arose as to whether consolidation could satisfy all of the distinct concerns of each of the regulators involved.¹¹⁸

In its final Report, the Group distinguished between homogeneous and heterogeneous groups in connection with which quantitative capital assessments could be made.

With regards to homogeneous groups, an accounting-based consolidation was recognised as being an appropriate technique.¹¹⁹ This involves a comparison, on a single set of valuation principles, of total consolidated group assets and liabilities, with the capital requirements at the parent company level being applied to the consolidated figures.

A number of separate techniques were, however, examined in connection with heterogeneous groups. While block capital adequacy, which involved the classification and aggregation of assets and liabilities according to risk types, could achieve an accounting-based consolidation in respect of heterogeneous groups, this was dependent upon the development of harmonised standards which was considered impracticable in the foreseeable future.¹²⁰

A sufficient insight into the risks and capital coverage involved with heterogeneous groups could, however, be achieved through one of three alternative techniques:

- (1) *Building Block Prudential Approach* This involved the use of the consolidated accounts at the parent company level;¹²¹
- (2) *Risk-Based Aggregation* This involved totaling the solo capital requirements of the regulated group and comparing the result with group capital;¹²² and
- (3) *Risk-Based Deduction* This involved looking at each company in turn, beginning at the lowest level of the group, with subsidiary investments being subject to a risk deduction element, calculated on the basis of the own funds of

¹¹⁸ While the group noted that the supervisory approach adopted should be flexible, it concluded that it was neither desirable nor possible to formulate a single supervisory technique applicable in all circumstances with the most appropriate approach generally depending on the structure and nature of the particular conglomerate involved.

¹¹⁹ *Ibid*, para 108.

¹²⁰ *Ibid*, paras 109-110.

¹²¹ *Ibid*, paras 111-115.

¹²² *Ibid*, paras 116-121.

the subsidiary assessed on a solo-plus basis, less the capital requirement of the subsidiary, multiplied by the proportion of shares held in the subsidiary¹²³

The Group concluded by recommending that each of these three techniques could form the basis of a set of minimum ground rules for the assessment of capital adequacy, the use of which could be developed on a mutual recognition basis.¹²⁴ A fourth total deduction approach was also considered which would eliminate double-gearing but not provide any group assessment of the risks involved.

The Report concludes by noting that the type and structure of the conglomerate in question may determine which of the four techniques may be most appropriate for supervisory use¹²⁵

Detailed recommendations with regard to subsidiaries, which are not wholly controlled,¹²⁶ provisions with regard to suitability and availability of capital surpluses,¹²⁷ and provisions concerning the supervision of groups which include substantial non-regulated entities are also provided.¹²⁸

(iii) Contagion

Contagion was specifically recognised as one of the most important issues facing supervisors in relation to financial conglomerates despite the advantages which may otherwise be available in terms of greater financial capacity and wider diversification of activities.¹²⁹ The Group was, however, concerned that contagion could arise from transfer of lack of market confidence to distinct parts of the group as well as through direct intra-group exposures.¹³⁰

The use of firewalls in connection with the prevention of inter-conglomerate contagion through restrictions on intra-group transfers, which would otherwise breach individual company capital requirements, was discussed.¹³¹

Although it was accepted that the provisions applicable to United States securities firms have been successful in the past, these firms were less likely to fail due to the highly liquid nature of their balance sheets and the lack of any predisposition to support other companies within the group.¹³² Banking groups, in contrast, were very sensitive to market funding and consequently prepared to prevent failure within the group.

¹²³ *Ibid*, paras 124-129.

¹²⁴ *Ibid*, paras 122-123.

¹²⁵ *Ibid*, paras 130-131.

¹²⁶ *Ibid*, paras 132-153.

¹²⁷ *Ibid*, paras 154-159.

¹²⁸ *Ibid*, paras 160-171.

¹²⁹ *Ibid*, para 48.

¹³⁰ *Ibid*, paras 49 and 50.

¹³¹ *Ibid*, para 51.

¹³² See Section 4 *supra*.

(iv) Intra-Group Exposures

It was recognised that specific difficulties arose with regard to intra-group exposures due to their exclusion from a consolidated balance sheet as a result of netting and due to the non-arms' length nature of the transaction.¹³³ To deal with the specific difficulties which arose, the Group recommended solo supervision, at both the subsidiary and parent company levels, with appropriate reporting obligations,¹³⁴ liaison between relevant supervisors and power to prohibit exposures where necessary.¹³⁵

Supervisors should also monitor the extent to which supervised institutions within a conglomerate may be exposed to funding or trading difficulties arising as a result of shifts in market confidence.

The Group also recommended that regulators be made aware in specific terms of the purpose of any intra-group exposures, whether of a long or short term nature, and whether they were self-liquidating or likely to be repeated or rolled over.¹³⁶ In such circumstances, regulators must ensure that capital is increased or activities limited to ensure that no unacceptable intra-group exposures arise.

Some members of the Group recommended the introduction of pre-determined limits on intra-group exposures to individual intra-group companies and on an aggregate basis and, possibly, imposing reporting obligations where intra-group exposures exceeded a certain size.

(v) Large Exposures at Group Level

The distinct approaches applicable to banking and insurance regulation in connection with large exposures were noted. Although credit institutions were typically subject to specific limits on solo and consolidated exposures, insurance undertakings generally had to comply with asset diversification rules or risk based capital incentives directed towards asset diversification.¹³⁷

The wide differences which existed, however, created considerable scope for regulatory arbitrage to such an extent that it was recognised that the gaps would not be completed within the foreseeable future.¹³⁸

¹³³ *Ibid*, para 56.

¹³⁴ The relevant data may include: gross commitments, amount, nature and residual maturity of commitments, profits and losses associated with intra-group transactions and confirmation that business is being conducted at market terms/conditions. *Ibid*. para 57.

¹³⁵ *Ibid*, para 63.

¹³⁶ These may arise from direct credit lines or from intra-group cross shareholdings, trading operations, central short-term liquidity management, guarantees and commitments and services provision such as pension arrangements.

¹³⁷ *Ibid*, para 64.

¹³⁸ *Ibid*, para 18.

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It was, however, agreed that a combination of large exposures to the same counterparty by different parts of the group could cause considerable difficulties to the stability of the group as a whole and, for this reason, a group-wide assessment had to be adopted. One solution was through the introduction of reporting obligations to the parent, or lead regulator, to ensure that they were able to assess significant group exposures to individual counterparties.

(vi) Conflicts of Interest

It was noted that specific conflicts of interest could arise where banking or insurance units within the conglomerate made loans or invested assets within the group outside usual approval processes, or where investors, with substantial holdings, in the conglomerate had separate contractual relationships with businesses within the group creating shareholder and creditor conflicts.¹³⁹

Although the Report makes no specific recommendations in these regards, the general recommendations with regard to management and shareholder controls within conglomerates and, in particular, management autonomy and suitability of shareholders, should assist the avoidance of dangerous conflicts of interest arising.¹⁴⁰

(vii) Fit and Proper Tests for Managers

Although supervisors generally had sufficient powers to confirm the suitability of managers of regulated firms, managers from other companies within the conglomerate and, in particular, from upstream entities, were not subject to any controls.¹⁴¹ Where control may be exercised directly, or indirectly, by such managers, supervisors should have extended powers of approval or review.¹⁴²

(viii) Transparency of Legal and Managerial Structures

Supervisors and regulators must be able to refuse to grant, or to withdraw, authorisation in circumstances where conglomerate structures were not sufficiently transparent and conducive to group supervision.¹⁴³

Supervisors and regulators should be aware of the legal and managerial structure of the conglomerate and be satisfied that all regulatory activities undertaken within the group are supervised by a supervisor who can be relied upon to supervise effectively and to provide the information necessary for group risk assessments. In connection with this, the lines of accountability

¹³⁹ *Ibid*, paras 73 and 74.

¹⁴⁰ See Section 6.IV.2 (9) and (10) *infra*.

¹⁴¹ *Ibid*, para 75.

¹⁴² *Ibid*, para 76.

¹⁴³ *Ibid*, para 77.

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within a conglomerate and the form the accountability takes must be clear. This may involve the use of up-to-date organisational charts and information about ownership and managerial structures.¹⁴⁴

In connection with large international financial conglomerates, the Group insisted that supervisors had adequate powers, both before and after authorisation, to obtain adequate information regarding corporate structures and to prohibit structures which impaired adequate supervision.¹⁴⁵

(ix) Management Autonomy

One specific difficulty identified in connection with management structures was the sufficiency of independence and authority of the management of the regulated entity. To ensure that conflicts did not arise between supervisory and group management requirements, it was necessary to ensure sufficient management autonomy in the regulated entity. For this purpose, supervisors had to know who was responsible for compliance with legal and supervisory requirements and be informed of any significant changes in shareholders of the regulated entity as well as significant management changes within the group.¹⁴⁶

(x) Suitability of Shareholders

A shareholder who exerted any material influence on a regulated firm should be subject to applicable fitness standards, both on authorisation and subsequently, with supervisors having adequate powers to intervene as necessary, for example, powers of disinvestment and removal or restriction of voting rights, although it was recognised this may not be possible where there were 100% or majority shareholders involved.¹⁴⁷

(xi) Rights of Access to Prudential Information

To ensure that separate regulators in one country and in overseas countries co-operated sufficiently to ensure the effective supervision of financial conglomerates, the Group recommended that:¹⁴⁸

Supervisory authorities must have sufficient legal powers to share prudential information with each other, including information on intra-group exposures subject to professional secrecy requirements;

¹⁴⁴ *Ibid*, para 78.

¹⁴⁵ *Ibid*, para 79. In connection with this the 1992 Basle Banking Supervision Committee's "minimum standards" were recommended; see Basle Committee, "Report on International Developments in Banking Supervision" (September 1992), *op. cit.*, n. 66.

¹⁴⁶ *Ibid*, para 80.

¹⁴⁷ *Ibid*, para 81.

¹⁴⁸ *Ibid*, para 85.

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Supervisors must actively exchange information, both nationally and internationally, either within a single category or between distinct categories of supervisor;

Supervisors must be able to obtain and share with other supervisors prudential information on non-regulated entities within the conglomerate to the extent that the information may be relevant for supervisory purposes.

The Group again recommended that the supervisors and regulators of the various component parts of a group should appoint the supervisor of a dominant business in the group to act as convenor where this was possible.¹⁴⁹ The convenor should then be responsible for ensuring that all authorities involved were supplied with all necessary information, subject to public and professional secrecy requirements, and the co-ordination of the risk assessment determination for the group as a whole. The convenor should also be responsible for the co-ordination of any necessary supervisory action, especially in circumstances where it was desirable that two or more authorities act simultaneously¹⁵⁰

In the final Report, the use of Memoranda of Understanding or Protocols are recommended although there is some disagreement as to whether their benefits outweighed the cost and time burden involved in agreeing them especially with regard to information exchanges where there was no clear cause for regulatory concern. The matter was left for determination between the particular supervisors involved.¹⁵¹

Although the development of cross-sectoral meetings in each country was considered the difficulties in organising such meetings on an international scale were recognised. Again no specific recommendations were made in this regard.¹⁵²

Where external auditors had concerns about the financial and operational condition of a regulated entity, or the group to which the entity belonged, they should be required to report their concerns to the relevant supervisors. Any confidentiality problems which could arise in connection with these reporting obligations should be corrected through appropriate legislation.¹⁵³

In connection with the external audit of the group as a whole, the Group recommended that the principle of appointing one firm to provide an overall assessment of the group should be considered further, notwithstanding the existing appointment of distinct auditors to different parts of the group.¹⁵⁴

¹⁴⁹ *Ibid*, para 86

¹⁵⁰ *Ibid*, para 87.

¹⁵¹ *Ibid*, paras 88-89.

¹⁵² *Ibid*, paras 90-91.

¹⁵³ *Ibid*, para 92

¹⁵⁴ *Ibid*, para 93.

(xii) Supervisory Arbitrage

Although it was recognised that the scope for supervisory arbitrage in relation to core activities was limited in most jurisdictions, the residual possibility of arbitrage should be prevented. This could be achieved by ensuring that the same types of risk undertaken within certain parts of the group were covered by identical amounts and structures of capital, irrespective of location, according to the same business, same risk, same rules principle, although this would require detailed harmonisation of banking, securities and insurance regulations.

In light of the unrealistic nature of this approach, the Group recommended the adoption of a more pragmatic, but limited, arrangement involving an early warning system whereby supervisors would be required to report to each other on the establishment of conglomerate entities within their jurisdiction and of the transfer of assets, liabilities or contingent liabilities between different parts of the group. This should enable supervisors to identify possible instances of arbitrage and to take appropriate remedial action at an early stage.

(xiii) Moral Hazard

Although the issue of moral hazard was not considered in any detail in the progress Report, in the final Report the Group was concerned that supervisors may create the impression that unregulated parts of a group are regulated or supervised, even if only informally as a result of information requests. No specific recommendations are, however, made in this regard.¹⁵⁵

(xiv) Mixed Conglomerates

In connection with mixed conglomerates, the Group was concerned about the additional difficulties which arose with regards to capital assessments since supervisory practices could not be extended to apply to substantial non-financial entities. The Group accordingly recommended the use of some form of ring-fencing, the simplest of which would be the use of an intermediate holding company to create a sub-financial group within the conglomerate.¹⁵⁶

Further recommendations are also made with regard to management quality, experience and independence in mixed groups to avoid additional contagion difficulties and information requests in connection with other group activity which might adversely effect the regulated entity.¹⁵⁷

¹⁵⁵ *Ibid*, para 96.

¹⁵⁶ *Ibid*, para 100.

¹⁵⁷ *Ibid*, para 101-103.

The Report concludes by noting the importance of more intensive co-operation between supervisors in the distinct fields of financial supervision involved and that with further work being undertaken on the identification of impediments to the exchange of such information.¹⁵⁸ Agreement was, however, possible on broad areas of approach which involved the development of group-wide supervisory practices, although this was without replacing solo supervision of individual group entities as such.¹⁵⁹

VI. The Joint Forum Progress Report, April 1997

The Joint Forum was established at the beginning of 1996 to take forward the work of the Tripartite Group.¹⁶⁰ The Joint Forum was set up to pursue practical means at domestic and international levels to facilitate the exchange of information between supervisors within their own sectors and between supervisors in different sectors and to investigate any legal or other matters which could impede the exchange of information between officials within their own and between supervisors in different sectors.¹⁶¹ The Joint Forum was also to examine means to enhance supervisory co-ordination including the advantages and disadvantages of establishing criteria to identify and define the responsibilities of a co-ordinator as well as to develop principles for the more effective supervision of regulated firms within financial conglomerates.¹⁶²

The Joint Forum published a Progress Report on its work in April 1997 in advance of the Denver G7 Summit. The Progress Report contained a number of provisions concerning exchange of information between supervisors, the work of a special Task Force which had been established to enhance the Joint Forum's understanding of the operations of internationally active financial conglomerates, the possible role and responsibilities of a co-ordinator with appropriate identification criteria and the development of a number of principles of supervision for application in particular areas of supervisory activity. An Interim Report was also prepared for its constituting committees, although this was not made publicly available.¹⁶³

¹⁵⁸ *Ibid*, para 175.

¹⁵⁹ *Ibid*, para 176.

¹⁶⁰ The Joint Forum is again made up of 25 persons representing the banking, securities and insurance sectors. An equal number of supervisors from each area attend from 13 countries with a representative from the EU Commission to co-ordinate with the related work carried on within the EU. As all 13 countries cannot have three representatives each, a system of allocation operates whereby the larger countries have 3 representatives, medium sized countries 2 and smaller countries 1.

¹⁶¹ See Mandate by the Bar Committee, IOSCO and the IAIS to the Joint Forum.

¹⁶² *Ibid*.

¹⁶³ See Progress Report by the Joint Forum on Financial Conglomerates, 9 April 1997. See also correspondence from Dr. T Padoa-Schioppa, Chairman of the Basle Committee, A.

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The Joint Forum subsequently issued a series of consultation documents under the title *Supervision of Financial Conglomerates* in February 1998 which take forward the more preparatory work outlined in the Progress Report. The consultation documents are concerned with capital adequacy, fit and proper standards, supervisory information sharing and the appointment and possible roles of a co-ordinator. The purpose was to obtain industry and supervisory comment before finalising its recommendations in the areas of supervision identified. A separate Supervisory Questionnaire was also prepared by a Mapping Task Force to collect information concerning the structure and operation of particular conglomerates.

In the Progress Report the Joint Forum describes the work carried out to date in connection with the exchange of supervisory information, its Task Force on marketing financial conglomerates, appointing a co-ordinator and developing appropriate principles of supervision

(a) Exchange of Information

The Joint Forum conducted a series of surveys with regard to the current practices of supervisors and the exchange of information nationally and internationally¹⁶⁴ and set up a Task Force to develop its understanding of the authority of national supervisors to share information and the nature of the information flows which operated between supervisors.¹⁶⁵

From the survey conducted, the Joint Forum concluded that although supervisors generally had power to exchange information this could often only be effected provided that certain conditions were satisfied which were principally concerned with protecting the confidentiality of the information concerned. A number of general principles were recognised to establish a basic framework for the transfer of information which the Joint Forum considered were already in place in each of its participating territories.¹⁶⁶ A number of

Neoh, Chairman of the Technical Committee of IOSCO and Mr G. Pooley, Chairman of the IAIS to Mr R. E. Rubin, Secretary of the United States Treasury, *op. cit.*, n. 71.

¹⁶⁴ Information was specifically requested with regard to the power of supervisors to exchange supervisory information, the limitations as to the type of supervisory information that can be exchanged and the conditions under which such information may be exchanged, the discretion available to supervisors as to whom supervisory information can be provided, the power of supervisors to keep information received from other supervisors confidential and existing agreements between supervisors for the exchange of confidential information. See Progress Report, para 6.

¹⁶⁵ *Ibid.*, para 7. See Sub-section (b) *infra*.

¹⁶⁶ The principles referred to comprised: supervisors receiving confidential information should be subject to adequate confidentiality provisions; information provided to other supervisors should be used only for purposes that are related to or compatible with the regulation of the financial institutions concerned including the enforcement of laws relating to such institutions; confidential supervisory information received by a supervisor should not be transmitted, whenever possible, to any other person without the agreement of the provider;

other limitations were also identified which restricted the operation of collaborative efforts in connection with information exchanges.¹⁶⁷ The Joint Forum would consider other impediments to the exchange of information and welcomed all national efforts to correct any deficiencies identified and to extend the authority of their officials as necessary. The use of formal information exchange agreements would also be considered further.¹⁶⁸

(b) The Task Force on Mapping

A special Task Force was also established to enhance the Joint Forum's understanding of the operations of internationally active financial conglomerates and their impact on supervisory methods.¹⁶⁹ A questionnaire was developed to allow the Task Force to map the activities of the conglomerates identified.¹⁷⁰ A second questionnaire was also sent to the

and it was desirable that an information-sharing framework between supervisors include, where legally permissible, appropriate reciprocity arrangements. See Progress Report, para 8. When supervisors could be compelled by courts to disclose confidential information to third parties, the provider of the information should be informed, whenever possible, in advance.

Ibid.

¹⁶⁷ In some cases, the relevant domestic statute does not expressly provide authority to exchange supervisory information with other supervisors. While this may not preclude the exchange of information nationally or internationally, express power to do so should be provided. In other cases, little statutory authority is provided to exchange information between authorities in other sectors apart from within the European Union. Again it was recommended that suitable legislation be adopted to correct this deficiency. In other cases, information may be exchanged with specific authorities the list of which may be unnecessarily restrictive without any appropriate mechanism to extend as necessary. *Ibid.*, para 12. In yet other cases, information exchanges could only take place where formal agreements had been entered into. While these may be desirable in practice, it is necessary to ensure that they are sufficiently flexible to ensure that information may be exchanged quickly enough in all circumstances including, for example, emergency situations. If formal requirements are required, resources must also be made available to facilitate their conclusions. *Ibid.*, para 13.

¹⁶⁸ The banking and securities authorities in the United Kingdom and the United States had submitted two papers in connection with their co-operative efforts with regard to the supervision of financial conglomerates including information flows and avoiding duplicated work. The European provisions relating to banking and securities firms would also be considered as well as the co-operative arrangements presently in place between the Netherlands and Belgium and between France and Belgium with regard to specific conglomerates. *Ibid.*, para 17.

Ibid., para 18.

¹⁷⁰ The questions related to: corporate legal and business structures including particulars as to internal and external influences on such organisational structures; management information as to the regulatory framework and organisational arrangements as to compliance with the regulatory requirements; corporate management structures, approaches to oversight and organisation of corporate control functions; areas of business, products and distribution channels and returns from those areas; sources, allocation methodology and responsibility for overall capital adequacies; purpose and monitoring of

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supervisors concerned to develop understanding of how they discharged their responsibilities with regard to the particular conglomerates involved.¹⁷¹

The mapping exercise was conducted in respect of 13 conglomerates with diverse business interests.¹⁷² The Task Force had been able to develop a series of important observations in respect of the groups' structures, inter-company relationships, risk information and the audit and internal controls of these groups which were of assistance in constructing an appropriate supervisory response to the challenges which they created.¹⁷³ The Task Force noted that in most cases the business line, management and control structure of the firms concerned was distinct from the structure of their legal entities.¹⁷⁴ The Task Force also identified a number of issues concerning the nature,

inter-company relationships; management, control and support functions in respect of various risks including, market, credit, liquidity, operating, insurance and legal; structure and responsibilities of internal audits; and scope of external audit and links with internal audit and regulators. See Progress Report, para 19.

¹⁷¹ The questionnaire was completed in respect of each supervisory sector in each country with information being provided in respect of the following: the purpose and objectives of supervision; the legal authorities with respect to the scope of licensing or registration, altering financial institutions powers and structures, obtaining reports and information, sharing information, making on-sight visits, taking intervention action and promulgating prudential and financial integrity standards; the methods of assessing financial conditions via monitoring, on-sight inspections and external auditors, independent actuaries and self-regulatory organisations; standards of supervision; mechanisms to enhance sound practices; and information flows about supervisors. Progress Report, para 20. The results of the questionnaires were distributed between all of the supervisory agencies represented on the Joint Forum to allow them to better understand their colleague's responsibilities and method of operation. *Ibid*, para 21.

¹⁷² This included seven banking groups with securities interests but limited insurance activities, 2 securities groups with banking and insurance operations, 3 insurance groups all of which had additional banking interests and 2 of which conducted securities operations and 1 mixed group with insurance, banking and securities interests. *Ibid*, para 22.

¹⁷³ *Ibid*, para 23.

¹⁷⁴ This did create certain efficiencies in business operations but it also created difficulties in management accountability and controls which raised further problems in terms of supervisory responsibility and methods of approach. *Ibid*, para 24. Supervisors had accordingly to understand the legal framework of the entities concerned as disclosed in their "boxes and lines" organisational charts but also their business and management structures. Complete and up-to-date corporate organisation information should accordingly be requested in connection with the following: all material risk taking subsidiaries and other entities controlled in whole or in part by the conglomerate including asset size, income, capital and the types of risks undertaken; all subsidiaries and other entities controlled in whole or in part by the conglomerate with significant operational activities, such as back office processing, including asset size, capital and income; the business line structure of the conglomerate, relevant legal entities participating in the business, location of management responsible for the business and any relevant parts of the business or its operations which are outsourced including the identity of the other company involved; the organisation and location of management of key global control functions such as financial control, risk management and internal audit of the conglomerate; regulated legal entities and relevant supervisors; and non-regulated legal entities. See Progress Report, para 25.

completeness and ease of interpretation of information available to supervisors of conglomerates¹⁷⁵

The Joint Forum also asked the Task Force to continue its work in analysing the information collected from the various conglomerates being mapped¹⁷⁶ and to revise the questionnaire used to obtain additional organisational structural and other information during the course of the mapping exercise.¹⁷⁷ This work into understanding the organisation and functioning of conglomerates was to be carried out in parallel with the study of the supervisory structures in place to assist in the identification of differences in national practice and possible impediments to co-ordination of activity and information flows between supervisors as well as possible overlaps and duplication of activity to avoid unnecessary regulatory burdens.¹⁷⁸ The results of these studies was to be used to develop options to enhance communication and to prepare specific principles for information sharing as well as in determining the need and possible roles of an information co-ordinator.¹⁷⁹ While the Joint Forum would prepare recommendations for each of its three

¹⁷⁵ These issues were concerned with the differences in information required, intra-group exposures and volume of information available. The complex relationships which existed between the firms legal entity, business line, management and control areas created differences in the information required by supervisors and information routinely collected or readily made available to supervisors having regard to its nature, quality and quantity. While certain key risk and control information may be centralised, other information may be spread across several legal entities; *ibid*, para 26. With the expansion of the more complex relationships new intra-group exposures were created including off-balance sheet exposures, related guarantees and service agreement relationships. While considerable differences existed in the monitoring of these exposures by firms, many of these were partial and only used to satisfy relevant regulatory requirements. *Ibid*, para 27. The large amount of information which would be of interest to supervisors also created difficulties. As important information may be increasingly centralised, supervisors from other countries may have difficulty in obtaining access to the information while as business lines are extended across legal jurisdictions information requests will be duplicated and regulatory costs increased. Information problems were accordingly significantly increased as more supervisors were involved and the business activities concerned spread across many jurisdictions. The wide diversity in the structure and nature of operation of each conglomerate also prevented the adoption of any single set of enhanced information-sharing and co-ordination rules. Such arrangements had accordingly to be as flexible as possible in dealing with the full range of information required but without imposing excessive regulatory costs. *Ibid*, para 28.

¹⁷⁶ This is to attempt to identify core information and its availability within conglomerates and to identify the options available to facilitate the sharing of relevant information between supervisors. The work should improve understanding of information needs in specific areas such as risk information, management communication with supervisors, inter-company relationships and exposures and audit and internal controls. *Ibid*, para 29.

¹⁷⁷ The object of the revision is to obtain a questionnaire which will be used by supervisors as a working tool to obtain valuable information from conglomerates on a unilateral, bilateral or multilateral basis. *Ibid*, para 30.

¹⁷⁸ *Ibid*, para 31.

¹⁷⁹ *Ibid*, para 32.

constituting committees in due course, supervisors were advised to exchange contact lists as an interim response to the enhancement of access to relevant information.¹⁸⁰

(c) Co-ordinator

The Joint Forum had considered the possible role and responsibilities of a co-ordinator and appropriate identification criteria. Although it was recognised that the supervision of regulated entities would be enhanced if this supervision was supplemented by the ability to assess risks from a group-wide prospective, it was stressed that each solo supervisor must retain full responsibility for the entities it had under its supervisory charge.¹⁸¹ Such a group-wide risk assessment would, however, require considerable co-operation between supervisors in connection with which a number of options have been considered including the designation of one or more supervisors to co-ordinate the transmission of relevant information.¹⁸² In considering the possible roles of the co-ordinator, rather than produce any fixed list of functions and responsibilities the Joint Forum had prepared a spectrum or menu of possible activities.¹⁸³ This was considered necessary in light of the distinct structure of particular conglomerates as well as the separate legislative frameworks within which supervisors operated and, in particular, the limitations on supervisors to act in concert. Supervisors would have complete discretion in choosing from the options available having regard to the particular circumstances in any specific case. With regard to identification criteria, general rules would be developed although supervisors would be left with sufficient discretion to make an appropriate appointment in any particular circumstances.¹⁸⁴

(d) Principles of Supervision

The Joint Forum had also been working to develop a number of specific sets of Principles of Supervision in particular areas. These included group-wide supervision, the fitness and properness of managers, large and intra-group

¹⁸⁰ *Ibid*, para 33.

¹⁸¹ *Ibid*, paras 34-36.

¹⁸² Different arrangements may have to be adopted for passing information from home to host and from host to home supervisors having regard to their distinct needs and responsibilities. *Ibid*, para 36.

¹⁸³ A limited selection of responsibilities would include acting as information co-ordinator in emergency situations. This could then be extended to include arrangements to facilitate the joint planning and execution of supervisory action especially in emergency situations. A more complete selection could include acting as responsible co-ordinator for a group-wide assessment of risks on an on-going basis. *Ibid*, para 37.

¹⁸⁴ *Ibid*, para 38.

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exposures, opaque structures and capital adequacy¹⁸⁵ In preparing these principles the Joint Forum has developed three particular themes:

(i) The foundation of effective supervision remains the solo supervision of regulated entities within financial conglomerates although this is to be complimented by a more general group-wide assessment of the risks involved.¹⁸⁶

(ii) Such a group-wide assessment of financial conglomerates is important to understand the intricacies of the organisations relationships with and the potential impact of regulated entities although this must not convey the perception that unregulated entities are subject to any official oversight regime which does not exist.¹⁸⁷

(iii) Regulated entities, their managers, directors and significant shareholders must properly discharge their responsibilities in ensuring the safety and soundness of the regulated entities involved and that the structure of the financial conglomerate does not impair the ability of supervisors to carry out their responsibilities.¹⁸⁸

With regard to capital matters, a separate Capital Adequacy Working Group was established to consider the techniques for assessing capital adequacy of heterogeneous conglomerates from a group-wide prospective and to develop basic principles for the assessment of such capital adequacy in heterogeneous financial conglomerates.¹⁸⁹ The Working Group was also asked to consider the creation of appropriate limitations on double or excessive gearing and how the consistent treatment of participation's of less than 100% could be secured. The techniques to be developed should, in so far as possible,

¹⁸⁵ Apart from capital adequacy, the principles being considered include: Supervision of financial conglomerates on a group-wide prospectus; Supervisor's ability to check on fit and proper standards of managers and their ability to ensure that shareholders meet adequate standards; Supervisory approach to large exposures and to intra-group exposures within financial conglomerates; and Supervisor's ability to intervene in structures that impair effective supervision. Progress Report, para 43.

¹⁸⁶ . . . It was noted that regulated entities are subject to specific legislative and other requirements and that the supervisory principles being developed by the Joint Forum will not be any way supersede those provisions. *Ibid*, para 44.

¹⁸⁷ This is necessary to ensure that expectations are not created that the unregulated operations within a conglomerate are subject to official supervision. This relates to the specific problem of moral hazard which can rise with regard to conglomerates in that the perceived scope of supervision may be unintentionally extended to include operations not within the specific remits of the authorities from each of the separate principal financial sectors involved.

¹⁸⁸ It is intended that the principles of supervision will stress the responsibilities of regulated entities in these regards. *Ibid*, para 46.

¹⁸⁹ See mandate to the Capital Adequacy Working Group reproduced in Progress Report, para 39. The Working Group has become known as the Spencer Group, adopting the name of its current Chairman.

provide prudent and consistent results in terms of risks and capital coverage.¹⁹⁰ The Working Group has subsequently reviewed the earlier work carried out by the Tripartite Group with respect to capital measurement techniques,¹⁹¹ reviewed three specific techniques to evaluate group-wide capital¹⁹² and considered the treatment of group participation's of less than 100% unregulated firms.¹⁹³

While the more detailed terms of the Interim Report prepared by the Joint Forum were not been made publicly available, a considerable amount of work has already been undertaken with regard to the supervision of financial conglomerates. A number of particular aspects of regulatory concern have been identified and properly dealt with by the Joint Forum. The attention given to information and capital problems was particularly welcome. It only remains to be seen what final provisions will be adopted. It must be stressed, however, that the Joint Forum was only established to consider specific matters with regard to conglomerates and was not intended to continue in operation after the publication of its final results. Whether the Joint Forum will be continued and in what form is still to be agreed.¹⁹⁴ In light of the importance of co-operation in the banking, securities and insurance areas some continuing vehicle must be established to ensure effective implementation and proper revision of the work of the Joint Forum.

VI. The Joint Forum - Supervision of Financial Conglomerates, February 1998

The Joint Forum subsequently issued a series of consultation documents under the title *Supervision of Financial Conglomerates* in February 1998. The Joint Forum had reviewed the various means to facilitate the exchange of information between supervisors within their own sectors and between supervisors in different sectors and had investigated the legal or other barriers which could impede the exchange of information between the authorities within

¹⁹⁰ *Ibid.*

¹⁹¹ The Working Group has attempted to identify certain generic issues which need to be addressed to insure that prudent results are obtained in applying the techniques identified by the early Tripartite Group's work. The existing solo capital adequacy requirements in each of the banking, securities and insurance sectors were assumed. *Ibid.*, para 40.

¹⁹² The object was to identify double or multiple gearing within a conglomerate and the difficulties created through excessive leverage. Unregulated businesses involved in similar activities such as leasing, factoring and re-insurance would also be taken into proper account; *ibid.*, para 41.

¹⁹³ Provisional agreement on the treatment of such participation's has been arrived at which operates by graduating scores according to degree of influence and control. *Ibid.*, para. 42.

¹⁹⁴ The matter was to be considered at the IMF/World Bank Conference in Hong Kong in October 1997.

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their own sectors and between authorities in different sectors. The means of enhancing supervisory co-ordination had also been examined including the advantages and disadvantages of setting out specific criteria to be used in identifying a co-ordinated and in defining the co-ordinator's responsibilities. Work had also been carried out with the development of principles for the more effective supervision of regulated firms within financial conglomerates. As a result of these efforts seven consultative papers were released. The purpose was to obtain industry and wider supervisory comment before finalising its recommendations.

(a) Capital Adequacy Principles

The objective of the paper on *Capital Adequacy Principles* was to provide banking, securities and insurance supervisors with principles and measurement techniques to facilitate the assessment of capital adequacy on a group-wide basis for heterogeneous financial conglomerates and to identify situations such as double or multiple gearing which may result in an overstatement of group capital and have a possibly adverse effect on the financial condition of regulated entities within the group. The reference to a heterogeneous financial conglomerate simply means a conglomerate involved with, at least, two different types of core (banking, securities or insurance) sector activity.

A number of capital rules were developed for use in determining suitable measurement or assessment techniques. These provide, in particular, for the detection of double or multiple gearing, avoidance of excessive leverage through the downstreaming of debt through equity holdings, monitoring the risks created by unregulated entities carrying on similar activities and assessing participations in regulated dependents. Three specific financial techniques are identified for use in assessing group-wide capital within a conglomerate comprising a building-block prudential approach, a risk-based aggregation method and a risk-based deduction method. Rather than impose any set of mandatory requirements in respect of capital, the Joint Forum concluded that authorities should have discretion in selecting which approach to follow and in determining how it should be applied in the circumstances of a particular conglomerate. The development of other systems in the future was not excluded. A separate Supplement to the paper on Capital Adequacy Principles was issued which contains worked examples of the measurement techniques identified.

The two consultative papers issued by the Joint Forum in the area of capital are valuable to the extent that they develop more specific rules for the assessment of the operation of capital measurement techniques and provide more detailed numerical expansions of their operations in practice. Although the papers appear to be concerned with measurement options or techniques only, it must be stressed that provided that the results obtained are fully

implemented in practice they may have a material impact on the total amount and distribution of capital which will have to be held within a particular group of companies. This will, however, require that all national capital rules are applied on a total group basis in practice and that all necessary allocation or distribution rules are in place to ensure that capital is appropriately dispersed throughout a group. Further work will have to be carried out in this regard. Even then, while the imposition of minimum financial standards can be a useful and important supervisory tool, capital regulation on its own can never be sufficient to protect the solvency of individual institutions or groups or the stability of markets generally.

(b) Fit and Proper Principles

In the separate paper on *Fit and Proper Principles* the Joint Forum considered the relevant standards to be applied to the managers and shareholders of a conglomerate. Seven guiding principles were set out in the paper.¹⁹⁵ These are generally designed to ensure that all relevant standards are applied to any directors, managers or controllers of any component part of a conglomerate where they may have a material influence on the activities or operations of any regulated entity also within the group. Where necessary national supervisors are required to consult with their counterparties in other related sectors or countries.

¹⁹⁵ See Joint Forum, *Fit and Proper Principles* (February 1998). The fit and proper guiding principles are as follows: (1) In order to assist in ensuring that the regulated entities within financial conglomerates are operated prudently and soundly, fitness and propriety or other qualification tests should be applied to managers and directors of other entities in a conglomerate if they exercise any material or controlling influence on the operations of regulated entities; (2) Shareholders whose holdings are above specified thresholds and/or who exert a material influence on regulated entities within that conglomerate should meet the fitness, propriety or other qualification tests of supervisors; (3) Fitness, propriety or other qualification tests should be applied at the authorisation stage and thereafter, on the occurrence of specified events; (4) Supervisor's expectations are that the entities will take the measures necessary to ensure that fitness, propriety or other qualification tests are met on a continuous basis; (5) Where a manager or director deemed to exercise a material influence on the operations of a regulated entity is or has been a manager or directors of another regulated entity within the conglomerate, the supervisor should endeavour to consult the supervisor of the other regulated entity as part of the assessment procedure; (6) Where a manager or director deemed to exercise a material influence on the operations of a regulated entity is or has been a manager or director of an unregulated entity within the conglomerate, the supervisor should endeavour to consult with the supervisors of the other regulated entities that had dealings with the unregulated entity as part of the assessment procedures; and (7) Supervisors should communicate with the supervisors of other regulated entities within the conglomerate when managers, directors or key shareholders are deemed not to meet their fitness, propriety or other qualification tests.

The rules developed will be useful in ensuring that all persons within a conglomerate whether directly or only indirectly concerned with a regulated entity are subject to proper examination and assessment. Assuming full implementation, a considerably extended process of review will be created. Of particular importance in this regard are the consultation rules. Although only framed as recommendations and not obligations, the conduct and processing of all relevant enquiries required will assist in developing early contact and more effective working relationships between all of the separate sets of authorities concerned with the activities of a particular conglomerate. It is interesting to note that no reference is made to requiring any particular supervisor to consider the interests of the conglomerate as such in making these assessments, only that those of the specific regulated entity concerned are not damaged. This reinforces the jurisdictional or statutory divisions which necessarily arise in that each supervisor is only obliged, and indeed entitled, to consider the position of the specific entity over which it is responsible.

(c) Framework for Supervisory Information Sharing

Separate consultative papers were issued concerning a *Framework for Information Sharing* and *Principles for Information Sharing*. The Joint Forum was concerned in the first paper to set out a general framework for facilitating information-sharing between supervisors of regulated entities. A Task Force had been established to examine the structure and operations of fourteen large financial conglomerates. A Conglomerate Questionnaire was produced and further information obtained on supervisory objectives and approaches and on the authority of supervisors to share information in countries represented in the Joint forum.

(d) Principles for Supervisory Information Sharing

In the second paper on *Principles for Supervisory Information Sharing*, five principles were developed with respect to the exchange of supervisory information between supervisors.¹⁹⁶ These are designed to build on and

¹⁹⁶ See Joint Forum, *Principles for Supervisory Information Sharing* (February 1998). The guiding principles set out are as follows: (1) Sufficient information should be available to each supervisor, reflecting the legal and regulatory regime and the supervisor's objectives and approaches, effectively to supervise the regulated entities residing within the conglomerate; (2) Supervisors should be proactive in raising material issues and concerns with other supervisors and supervisors should respond in a timely and satisfactory manner when such issues and concerns are raised with them; (3) Supervisors should communicate emerging issues and developments of a material and potentially adverse nature, including supervisory actions and potential supervisory actions, to the primary supervisor in a timely manner; (4) The primary supervisor should share with other relevant supervisors information affecting the regulated entity for which the latter have responsibility including supervisory actions and potential supervisory actions except in unusual circumstances when supervisory

enhance existing information sharing arrangements especially those operating on a cross-sector basis.

The work carried out in preparing the framework paper was clearly of considerable value in allowing supervisors more fully to understand the operations of large internationally active conglomerates. The basic analysis developed will also be of value in following how the groups and other conglomerates concerned develop over time. Of much more importance are the basic exchange rules established. These are generally based on the concepts of sufficiency of information, proactive co-operation, full communication of emerging issues, the use of a primary supervisor to distribute relevant information and the development of contact and trust. It is essential that all necessary information is fully circulated within any specific supervisory group which is concerned with the monitoring of the activities of a particular conglomerate. In light of this, the limited amount of more detailed guidance provided is surprising. Rather than just set out some very basic principles concerning the general relationship between supervisors it may have been of more value to try to construct some more detailed operational rules to govern the mechanics of information transfer. These could have dealt with such matters as request procedures, transfer channels, verification rules and any special crisis procedures to be provided for. Again this is a very important development and significant first step in the construction of an appropriate set of information transfer rules and mechanisms. This is, however, something which the international organisations and, in particular, the Basle Committee have been considering for some time. The fact that only limited progress has been achieved in this regard has to be considered to be very disappointing.

The most useful vehicle which has been developed to date for use in practice is the conclusion of appropriate Memoranda of Understanding (MoUs).¹⁹⁷ Only IOSCO and the IAIS, however, has attempted to provide any general guidance with regard to their content and operation apart from the more specific arrangements entered into between securities and futures authorities as part of the Windsor Declaration follow-up work. In light of the importance of securing effective information exchange arrangements, more specific guidance in this regard may have been helpful especially in this much more difficult area. It may have been that the authorities present considered that sufficient progress had already been made in this regard in practice or that it was best left to future bilateral discussion. Such a fundamentally non-transparent approach would, however, be very unfortunate.¹⁹⁸

considerations dictate otherwise; and (5) Supervisors should purposefully take measures to establish and maintain contact with other supervisors and to establish a climate of co-operation and trust amongst themselves.

¹⁹⁷ See Chapter 4, Sub-section 1.(III).

¹⁹⁸ The most significant difficulty which also arises in this area in practice is in connection with national bank and related financial market secrecy constraints. The success of even the most liberally drafted MoU will always be dependent on the operation of national

Apart from the information specific principles announced, the Joint Forum may also have considered trying to develop some more general co-operation rules. This is clearly implied in some of the draft principles published although it may have been helpful to issue more detailed information transfer provisions and more general co-operation rules separately.

(e) Co-Ordinator

Assuming the goal of improving co-operation through information-sharing, the objective of the Joint Forum's *Co-Ordinator* paper was to provide supervisors with guidance in respect of the rules to be applied in identifying a co-ordinator or co-ordinators and with a catalogue of elements of co-ordinations from which supervisors may select the role and responsibilities in emergency and non-emergency situations.¹⁹⁹ Various allocation roles to be applied and a menu of possible functions were provided. This is a complex issue.²⁰⁰ Despite support by the British Government and supervisory authorities for the appointment of some form of lead regulator with a number of defined responsibilities including the co-ordination of information-sharing arrangements, other countries and agencies have not been so supportive. As a compromise a more general set of rules were produced concerning the initial need for a co-ordinator and then for his identification and possible function.

A menu of optional functions was also provided in the form of a catalogue of possible elements of co-ordination. This consisted of various

secrecy rules (as well as more general public policy exceptions). A concerted effort must accordingly be made to ensure that all unnecessary restrictions are removed on the free passage of information between all national and sector authorities. The operation of such constraints in practice must be examined by the Joint Forum and any deficiencies corrected by the national governments concerned. A general policy of non-transparency in relation to information transfers will not assist in this process. *Ibid.*

¹⁹⁹ See the Joint Forum, *Co-Ordinator* (February 1998). The following guiding principles are proposed in this regard: (1) Arrangements between supervisors relating to the co-ordination process should provide for certain information to be available in emergency and non-emergency situations; (2) The decision to appoint a co-ordinator and the identification of a co-ordinator should be at the discretion of the supervisors involved with the conglomerates; (3) Supervisors should have the discretion to agree amongst themselves the role and responsibilities of a co-ordinator in emergency and non-emergency situations; (4) Arrangements for information flows between the co-ordinator and other supervisors and for any other form of co-ordination in emergency and non-emergency situations should be clarified in advance where possible; (5) Supervisor's ability to carry out their supervisory responsibilities should not be constrained by reason of a co-ordinator being identified and a co-ordinator assuming certain responsibilities; (6) The identification of a co-ordinator and the determination of responsibilities for a co-ordinator should be dedicated on the expectation that those responsibilities would enable supervisors better to carry out the supervision of regulated entities within financial conglomerates and (7) The identification and assumption of responsibilities by a co-ordinator should not create a perception that responsibility has shifted to the co-ordinator.

²⁰⁰ See Chapter 3, Section 1.

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functions relating to information sharing, group-wide assessment and supervisory activities. Differences in the underlying legal and operational frameworks within which supervisors in different countries operate required that a more general catalogue of elements of co-ordination was developed rather than a fixed set of functions. These also prevented the adoption of a specific set of factors in connection with the identification of the co-ordinator. These factors included differences in legal framework, statutory authority of individual supervisors, accountability to legislative and other bodies, capabilities and resources, supervisory techniques and remedial actions available, ability to share information cross-sectorily and cross-border, business activities, risk profile and structure of conglomerates and availability of information from conglomerate to supervisors. Although understandable in light of the differences which exist it is regrettable that a more clearly defined set of allocation rules and functions could not be agreed at this stage. This should, however, not prevent the conclusion of appropriate agreement on the identity and role of a co-ordinator or co-ordinators in any particular case in practice. Much will depend upon the quality of the relationships which already exist between the supervisors concerned and how they are developed in the future.

The content of the Co-ordinator Paper is possibly the most disappointing aspect of the Joint Forum's work to date. The creation of effective co-operation and co-ordination mechanisms between all of the separate national and sector authorities involved with the work of a single conglomerate is essential to the monitoring and control of all of the separate financial activities undertaken. This, in turn, is essential to the protection of the stability of each of the separate sectors involved as well as to avoiding the problem of inter-sector loss transfer.

To allow for a certain degree of flexibility of operation is understandable but to continue to proceed by stressing the separate powers and responsibilities of each of authorities involved is very regrettable. Rather than promote, this may dilute the level of co-operation achieved in practice. The presumption should be one of co-operation and joint effort rather than discharge of individual obligation and function. A number of difficult legal issues do arise in ensuring that each authority properly discharges its obligations in connection with the supervision of a particular regulated entity. This can, however, still be completed in co-operation with other authorities. Indeed it has now to be accepted that this may be impossible to carry out without the co-operation of other agencies. The co-ordination rules agreed to date unfortunately are more remarkable for their protection of specific agency powers rather than attempt to create any integrated co-operative mechanism.

(f) Supervisory Questionnaire

A separate Supervisory Questionnaire was prepared by the Mapping Task Force to collect information on supervisor's objectives and approaches. Authorities were invited to complete the questionnaire in respect of all conglomerates within each sector within their territories in all cases where there was a significant presence. It was hoped that this would permit a comprehensive matching of supervisory structures to be made against the conglomerates' business structures. This will in turn allow areas where specific attention or measures are required to be identified. Although at a very early stage of development this may become a very useful analytical tool in understanding how conglomerate structures operate on a supervised and global basis. Of some surprise is the lack of specific information requested with regard to the identity and supervisor of particular conglomerates. Fourteen conglomerates were examined by the Task Force in connection with the Framework for Supervisory Information sharing paper. Although the separate Conglomerate Questionnaire used was drafted for a distinct purpose, an examination of the correlation between the different sets of data obtained under that paper and the Supervisory Questionnaire may have been of considerable value. The Joint Forum was not, however, concerned with the supervision of any particular entity but only with the development of more effective sets of supervisory principles as outlined in the consultative documents produced. Any more detailed examination of the results obtained under the Conglomerate Questionnaire may have been considered to have amounted to a review of the quality of the supervision exercised by the particular authorities concerned.

The issuance of the consultative documents by the Joint Forum was significant in that it allowed the market participants involved in each of the sectors concerned to assess and comment on the prospective rules to be developed to monitor and control their activities. The generality of the rules developed today was unfortunate although understandable at this stage in light of the number of countries and different sectors involved. Of possibly more importance was the understanding developed in conducting the preparatory work involved as well as in the degree of co-operation established between the authorities in the distinct sectors concerned. While a valuable set of basic principles concerning the supervision of financial conglomerates may still be produced, of more practical importance may be the degree of effective co-operation and co-ordination of activity which can be achieved in relation to the supervision of particular complex financial groups.

7. The Basle Conglomerate Response

It is clear that a number of specific issues of concern have been identified in connection with the supervision and regulation of financial conglomerates. The main issues considered by the Basle Committee and the Joint Forum have included supervisory methods, capital controls and intra-group exposures, management structures and suitability of managers, ownership and suitability of shareholders, intra-group conflicts of interest and various ancillary issues including controlling supervisory arbitrage and moral hazard

The most important observation to be made about the studies conducted to date, however, is that they are essentially selective in their scope of coverage, generally of a technical but still of a largely superficial nature at this stage while a number of important larger issues have not yet been considered

I. Regulatory Structures and Supervisory Equivalence

None of the reports has attempted to deal with the sensitive but fundamental issue of what alternative overall supervisory and regulatory structure or approach should be adopted for cross-sector market control in the future. Rather than attempt to discuss the possible options or even how some degree of convergence may be achieved over time between each of the sectors concerned, the matter of the proper overall regulatory approach to be adopted to the supervision of conglomerates has not been raised. It is simply assumed that separate sector based systems of monitoring and control will be continued for the indefinite future. The implication is that none of the groups felt that the issue fell within their scope of consideration or simply that the matter was too difficult or sensitive at this stage to consider. Considerable problems will, however, arise in the future in so far as all of the principal financial services sectors continue to develop and conduct their supervisory and regulatory practices in fundamentally separate ways. This is a very difficult issue and although it would be impossible to alter the traditional nature and practices of each of the sectors involved in a short period of time or certainly to abolish all sector specific supervision outright, the issue of adequate overall supervisory analysis is important and the issues which arise in this regard and some possible options or solutions should have considered. A more integrated approach to the control of these increasingly complex cross-sector groups must be developed in early course.

Apart from the attempting to deal with the basic issue of how to construct a new overall approach to conglomerate supervision and control,²⁰¹ one of the most important residual issues still to be dealt with is to attempt to

²⁰¹ The issues of conglomerate supervision is considered separately in Ch 4.

develop some form of equivalence in terms of supervisory and regulatory returns or reporting requirements as well as in corporate and accounting standards to allow some comparison to be made between the activities carried out within the different parts of the conglomerate. Work in this area has been restricted to agreeing possible means for calculating total group capital but that on the basis of the fundamentally different sets of returns submitted by distinct sector units within a larger group.²⁰² As yet there is no equivalence whatsoever between the returns and accounts prepared from banks and insurance companies although some progress has been made in comparing banks and securities firms. Even within specific industries such as banking, a number of international models are used and only the rating agencies have made any serious attempts to prepare common standards for comparison purposes at this stage.

II. Loss Transfer - Structural Regulation or Capital Adjustment

Apart from attempting to secure some form of equivalence between supervisory returns and accountancy standards, the most serious residual issue is that of securing a sufficient degree of loss insulation between the separate parts of the conglomerate. It is essential that the more volatile parts of the conglomerate should not be allowed to threaten the stability of the more sensitive parts such as the banking operations especially where they may have large national currency or foreign exchange payment exposures. The two principal options remain the United States structural separation model and the European trading book system although the supposed strength of the former is being constantly eroded through political and legislative intervention.²⁰³

In so far as the United States and Japan may further dilute the distinctions maintained between banking and securities activities and insurance operations, the United States will have to consider how to ensure that the stability of a group is not threatened by the collapse of one operation only. Although the United States may consider developing a capital model such as that in use in the Europe, the present state of its capital controls especially with regard to broker-dealers would have to be very radically revised to bring them up to European standards.²⁰⁴

IV. Internal Risk Management

Again the effectiveness and efficiency of internal decision-taking, reporting, review and record procedures is of crucial importance. In the case of

²⁰² See Sub-section 6.VI (a) *supra*.

²⁰³ See Chapter 3, Section 2.IV.

²⁰⁴ See R. Dale, *Risk and Regulation in Global Securities Markets* (1996), Ch 3.

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conglomerates, these will have to be developed even further to ensure that such procedures operate effectively at the group level and within each component part. In certain cases, however, a proper degree of management autonomy would have to be secured. In so far as this need for group operability and unit autonomy may come into conflict appropriate systems will have to be set up which are capable of proper examination, inspection and verification by supervisors.

III. Residual Structural Conflicts

As has been mentioned by the Tripartite Group and by the Joint Forum in their final reports a large number of more technical regulatory issues will arise in connection with group operations such as intra-company transactions of various kinds, suitability of managers and shareholders, conflicts of interest and rights of access to information. Work in this regard should focus on ensuring that all specific sector control requirements operate effectively in larger group situations. It remains to be seen how all of these issues will be resolved in practice.

It must be hoped that the level of contact already developed between the respective supervisors from each of the principal areas of financial activity can continue to work closely together to ensure that any operating difficulties which may arise in practice can be quickly and effectively dealt with.

It has also to be hoped that the Joint Forum can produce a much more comprehensive and substantial set of final papers which can deal with all of these more technical issues in more detail to ensure that a complete set of rules or, at least, regulatory options is available to all supervisors in practice in their dealings with conglomerates.

V. Crisis Management and Market Support

Very significant difficulties also remain in developing an appropriate crisis management and lender of last resort response in conglomerate situations. Although it is easy to set out a list of possible lender of last rules for the banking sector, these are not always easy to apply in practice. More considerable difficulties will then also arise in attempting to extend these to apply in more complex support operations where public funds have to be used in a number of jurisdictions where a single conglomerate is involved in a number of distinct sectors. Again it is very regrettable that these issues were not considered by either the Basle Committee or the Joint Forum although some recent work has begun in the area of international market support

generally.²⁰⁵ It remains to be seen how this might be taken forward in the future.²⁰⁶

8. Conglomerate Law - Conclusions and Comment

In light of the continuing growth and importance of complex financial and mixed conglomerates in global markets, it is essential that an effective and complete set of supervisory and regulatory rules and practices are developed, in early course, to protect the continued growth and stability of all the markets affected.

One obvious difficulty which has arisen is in connection with the distinct structural approaches adopted to risk separation within the United States and Japan, on the one hand, and Europe and many other countries, including the emerging markets, on the other, with the consequent parallel development of complex Glass-Steagall and universal bank and bankassurance based groups in the new single global markets of the 1990s and the complications which that has created in developing common standards of comparison and equivalence.

Of more importance, however, are the very basic differences inherent in the three principal financial sectors involved with regard to operational and solvency risks and ultimate susceptibility to systemic collapse, in particular, as a result of possible loss transference within a single conglomerate.

It is in trying to achieve some comparable measures of supervisory and regulatory equivalence in respect of these core differences and to ensure a sufficient level of risk containment or insulation, but without unnecessarily limiting the proper competitive development of the markets, that the most significant challenges lie in international convergence.

It has to be hoped that the earlier work of the Tripartite Group of Regulators can now be taken forward in the more formal Joint Forum and that an agreed set of common rules, or international guidelines, for the effective supervision of conglomerates can be developed in early course. The earlier work of the Tripartite Group to date has to be commended for the considerable results already achieved.

With regard to the general development of global conglomerate law, it is clearly essential that complete supervisory systems are developed which facilitate the effective supervision of the activities of financial and mixed conglomerates and of their legal and management structures. Appropriate reporting obligations must be placed on regulated entities and effective exchange of information systems maintained between all of the relevant

²⁰⁵ See *Report of the Working Group on International Financial Crises* (October 1998) cited in Introduction, n. 20.

²⁰⁶ For further discussion see, Chapter 3, Section 2.XII.

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regulatory authorities within and between each country with which a regulated entity may be involved.

In addition to these general supervisory arrangements, more detailed systems must be developed with regards to the assessment capital sufficiency within a group which, in particular, include confirmation of capital adequacy, capital quality and capital distribution within a group. In the event of common or harmonised standards being inappropriate, or impossible to agree, a final set of supervisory options in respect of capital must be adopted which secures a sufficient degree of equivalence in terms of risk containment or insulation and which is capable of mutual acceptance by all participating authorities.

With regard to specific regulatory controls, appropriate systems must be developed to secure the suitability of management, at the regulated entity and group level, as well as proper controls on controlling shareholders and participations in subsidiary companies or joint venture arrangements. All supervisors must have the power to refuse, withdraw or restrict authorisation where a group, or any part of a group, is not subject to effective supervision which powers might be extended to include the giving of directions as to the location for incorporation or structure of operation.

Appropriate safeguards will have to be developed to ensure that the all risks associated with actual, or potential, conflicts of interests can be properly dealt with failing which business or trading restrictions may have to be imposed on specific undertakings.

External auditors must be placed under appropriate reporting obligations while every possible effort must be made to develop necessary convergence in national and international accountancy standards in addition to the commonly use United States GAAP Rules which may be far from appropriate in many cases.

Although a considerable degree of work has already been undertaking in developing adequate systems of co-operation and exchange of information between national and international regulators, these efforts must be continued to ensure that an effective network of global supervisory and regulatory relations is established and that they are based on a sufficient degree of contact and confidence to ensure the effective supervision of all national and international conglomerates.

At the present time, the most important operational guidelines in place are the 1992 Basle Principles for the Supervision of Financial Conglomerates until these are replaced by the Joint Forum's final proposals on the Supervision of Financial Conglomerates. Although relatively insubstantial in their terms, the Joint Forum's proposals do provide a very valuable set of rules, or guidelines, for the proper identification and treatment of the principal difficulties which arise in connection with the supervision of financial and mixed conglomerates. Further work is, however, necessary in expanding each of these sets of provisions and with ensuring that the outline co-ordinator rules work

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effectively in practice. In light of the importance of this aspect of the Joint Forum's work it is considered in further detail in the following Chapter.

Every attempt has to be made to ensure that as many countries as possible accept, and effectively implement, the agreed standards for the supervision of financial conglomerates in all relevant areas of activity. The work of the Basle Committee has, again, been particularly impressive in this regard especially through the relationships developed with other supervisory authorities, or regional groupings of supervisors, throughout the world. It only has to be hoped that securities and insurance regulators can develop comparable consistency in support for the new rules in their respective areas.

In so far as certain countries, or specific financial centres, may be reluctant to introduce, or enforce, the agreed standards for reasons of competitive, or comparative advantage, in a particular financial sector, all available forms of economic or political pressure must be developed to ensure that a complete global response is developed with regard to the difficulties identified in connection with conglomerate forms of business. It is essential that any faults which may develop in the supervision of an individual institution are corrected at an early stage failing which supervisors must exercise their powers of restriction or revocation.

The provisional systems of new conglomerate law which are beginning to be developed in many countries are clearly very important steps in the creation of a larger global operation for the effective control and management of internationally active financial institutions. In connection with this, every effort should be made to ensure that domestic laws or administrative practices, faithfully and fairly implement the relevant international guidelines to ensure that all providers of financial services can compete on safe, but equal terms, without any local market distortions being created and the possibility of regulatory arbitrage in the area of conglomerate supervision.

It is, of course, essential that these domestic provisions, and the international rules on which they are based, are regularly reviewed and revised to ensure that flexible but effective responses are always possible as the structure and operation of the markets and financial institutions change. Every opportunity should also be taken in developing the new rules to extend the effectiveness of any related controls, for example, with regard to money laundering or anti-fraud measures, or in any other important area of legal or regulatory concern.

One area of considerable residual difficulty may arise in connection with the co-ordination of national and international lender of last resort activities. This is clearly important in light of the increasingly close relations, and consequent interdependence, being created between all domestic and international financial markets. Even if it is impossible to achieve complete agreement on this sensitive issue in the short-term, further efforts should be made to develop appropriate understandings or general guidelines over time to

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ensure that contagion caused by a particular conglomerate does not result in national or international market collapse.

A considerable amount of significant preparatory work has already been undertaken in the area of conglomerate supervision and a substantial amount of initial progress achieved. It can only be hoped that the success of these efforts can continue and that a complete and effective set of controls for the supervision of financial conglomerates can be developed and given effect to, in early course, to ensure that all national and international financial markets can continue to develop in a safe and stable manner and that the extensive opportunities being created in the new global financial services areas can be fully realised

**Institutional Investors, Corporate
Governance and the New International
Financial Architecture**

Professor Ian Ramsay

ABSTRACT

As a result of the recent economic crisis in south-east Asia, organisations such as the IMF, OECD and APEC have focused upon the development of principles to prevent future crises. Among these principles are ones that concern corporate governance. There are a number of ways in which corporate governance practices can be improved. An important question is whether institutional investors, because of their substantial and increasing shareholdings, can improve the corporate governance practices of companies in which they invest. The paper examines the role of institutional investors in corporate governance and reports the results of a study of the views of institutional investors on corporate governance.

INSTITUTIONAL INVESTORS, CORPORATE GOVERNANCE AND THE NEW INTERNATIONAL FINANCIAL ARCHITECTURE

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**International Conference on Challenges of the
New International Financial Architecture**

University of Hong Kong

4-5 June 1999

- **Improving the international financial architecture**
- **Development of corporate governance principles**
- **Definitions of corporate governance**
- **Why is corporate governance important?**
- **International interest in corporate governance**
- **Corporate governance mechanisms**
- **Institutional investors - international ownership differences**
- **Implications of the growth of institutional investors:**
 - **for the informational efficiency of the capital markets**
 - **for corporate governance**

IMPROVING THE INTERNATIONAL FINANCIAL ARCHITECTURE

Objectives:

- ❶ Foster effective supervision and regulation
- ❷ Improve institutional infrastructure
- ❸ Improve corporate governance

Source: IMF (1998)

DEVELOPMENT OF CORPORATE GOVERNANCE PRINCIPLES

- **OECD Principles (1999)**
 - rights of shareholders
 - equitable treatment of shareholders
 - role of shareholders in corporate governance
 - disclosure and transparency
 - role of the board of directors
- **APEC Principles (1998)**
 - timely and accurate disclosure of information
 - equitable treatment of shareholders
 - establishment of clear rights and responsibilities of shareholders, directors and managers
 - establishment of effective and enforceable accountability standards

Legal protections for external financiers of firms

	Shareholder Protections	Creditor Protections	Degree of Judicial Enforcement
Thailand	3	3	5.9
Malaysia	3	4	7.7
Korea	2	3	6.7
India	2	4	6.1
Indonesia	2	4	4.4
Philippines	4	0	4.1
Latin America	2.5	1	6.2
U.S.	5	1	9.5
U.K	4	4	9.4
Japan	3	2	9.4
Germany	1	4	9.4

Source: La Porta et al (1998)

DEFINITIONS OF CORPORATE GOVERNANCE

- The system by which companies are directed and controlled

Cadbury Committee (UK)

- Narrow definition:

“the ways in which suppliers of finance assure themselves of getting a return on their investment”

Professors Shleifer and Vishny (1997)

- **Broader definition:**

“the relationship among various participants in determining the direction and performance of corporations. The primary participants are (1) the shareholders, (2) the management (led by the chief executive officer), and (3) the board of directors...Other participants include the employees, customers, suppliers, creditors, and the community.”

Monks and Minow (1995)

- **Implications of different definitions**

WHY IS CORPORATE GOVERNANCE IMPORTANT?

- **Good corporate governance practices**
 - **will reinforce the confidence of investors**
 - **may reduce the costs of capital**
 - **may result in more stable capital flows**

OECD Corporate Governance Principles (1999)

THE INTERNATIONAL INTEREST IN CORPORATE GOVERNANCE

- **91 World Bank projects with “corporate governance components” (May 1999)**
- **The Cadbury Report - UK 1992**
The Financial Aspects of Corporate Governance
- **The Hilmer Report - Australia 1993**
Strictly Boardroom
- **The American Law Institute Report - USA 1994**
Principles of Corporate Governance
- **Bosch Report - Australia 1993**
Corporate Practices and Conduct

- **Donaldson Report - American Society of Company Secretaries 1994**
Catalysts for Corporate Governance
- **King Committee Report - South Africa 1994**
- **Toronto Stock Exchange Report - Canada 1994**
Where Were the directors?
- **English Chartered Accountants in Business - UK 1995**

- **International Capital Markets Group - 1995**

Who Holds the Reins?

- **Hong Kong Society of Accountants - 1996**

Corporate Governance

- **CalPERS - USA 1996**

Global Corporate Governance Principles

- **Canadian Standing Senate Committee on Banking, Trade and Commerce - 1996**

Corporate Governance

- **Corporate Governance Forum - Japan 1997**

Corporate Governance Principles

- **Hampel Committee on Corporate Governance - UK 1998**

- **APEC Symposium Report - 1998**

Corporate Governance in APEC

- **OECD Taskforce on Corporate Governance - 1999**

Principles of Corporate Governance

Corporate Governance Mechanisms

World Bank - 1998

Stakeholders

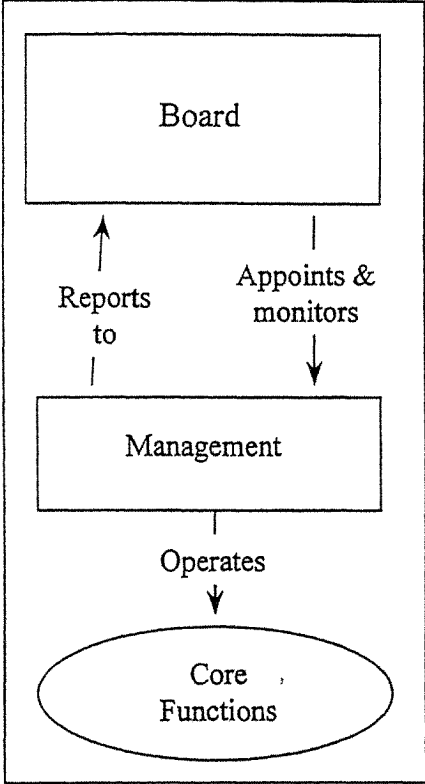
Internal Governance
Incentives

External Governance
Incentives

Labour



Shareholders



- Governance Rules
- Accounting & Auditing Standards
 - Ownership Rules
 - Shareholder Rights
 - Company Law
 - Contract Enforcement
 - Bankruptcy
 - Takeover Rules

- Financial Sector
- Debt
 - Credit Information
 - Collateral
 - Equity

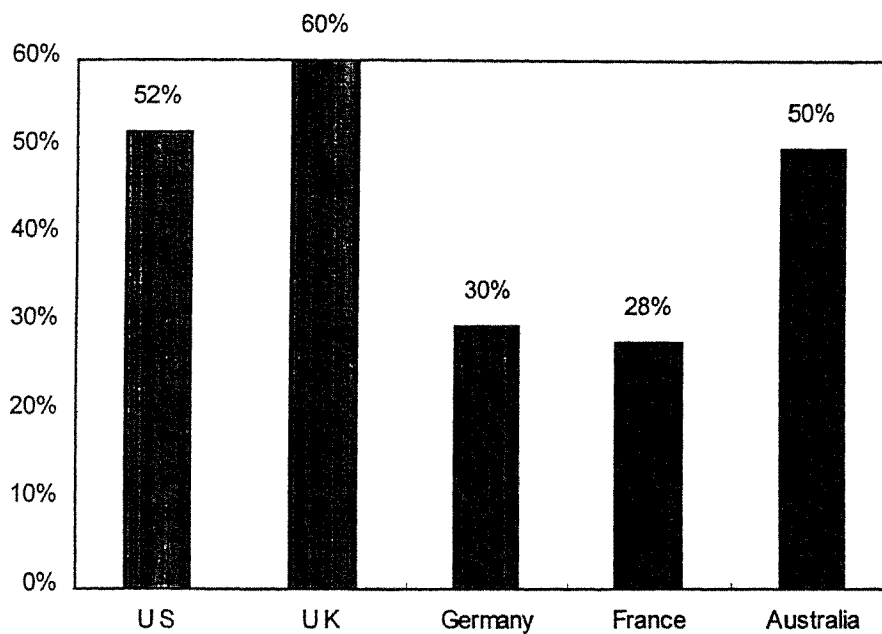
- Markets
- Product
 - Labour
 - Competition Policy
 - Corporate Control



CORPORATE GOVERNANCE MECHANISMS

- **directors' and officers' legal duties**
 - **structure of the board of directors**
 - **proportion of independent directors**
 - **separate role for CEO and chair of the board**
 - **auditors**
 - **institutional investors**
 - **takeovers**
 - **disclosure of information by companies**
 - **the product market in which the company operates**
 - **the capital market**
-
- **the labour market for managers**
 - **executive remuneration**
 - **shareholdings by managers/directors**
 - **ownership concentration**
 - **corporate financial policy**
 - **shareholder litigation and voting**
 - **insolvency law**
 - **intervention by regulators**

SHAREHOLDINGS OF INSTITUTIONAL INVESTORS As % of total market capitalization



Source: Wymeersch (1998) and other sources

ASSETS OF INSTITUTIONAL INVESTORS (G-7 COUNTRIES)

Country	Per cent of GDP
United Kingdom	176.0
United States	158.6
Canada	89.2
Japan	87.0
France	74.0
Germany	48.9
Italy	29.1

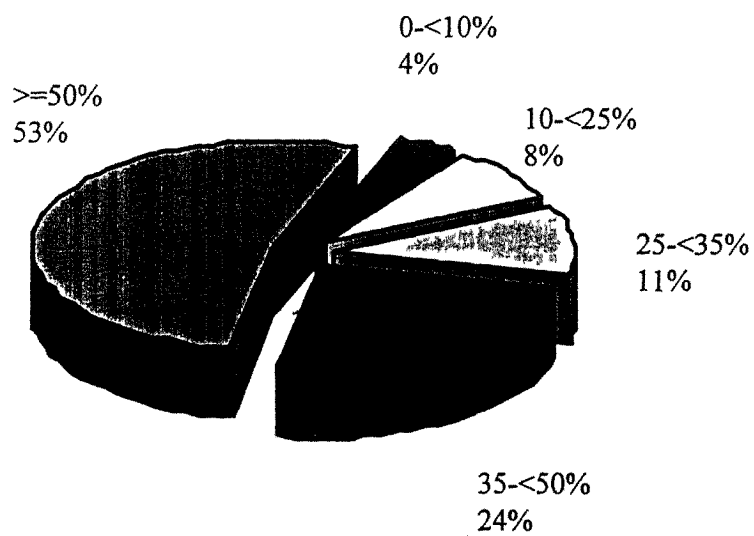
Source: International Monetary Fund (1998)

Control of Publicly Traded Companies in East Asia

Country	Number of Corporations	Widely Held	Family	State	Widely Held Financial	Widely Held Corporation
Hong Kong	330	7.0	71.5	4.8	5.9	10.8
Indonesia	178	6.6	67.3	15.2	2.5	8.4
Japan	1240	85.5	4.1	7.3	1.5	1.6
Korea	345	51.1	24.6	19.9	0.2	4.3
Malaysia	238	16.2	42.6	34.8	1.1	5.3
Philippines	120	28.5	46.4	3.2	8.4	13.7
Singapore	221	7.6	44.8	40.1	2.7	4.8
Taiwan	141	28.0	45.5	3.3	5.4	17.8
Thailand	167	8.2	51.9	24.1	6.3	9.5

Source: Claessens, et al (1999)

OWNERSHIP OF HONG KONG LISTED COMPANIES By single or family shareholder



Source: Hong Kong Society of Accountants (1997)

IMPLICATIONS FOR THE INFORMATIONAL EFFICIENCY CAPITAL MARKETS

Institutions typically:

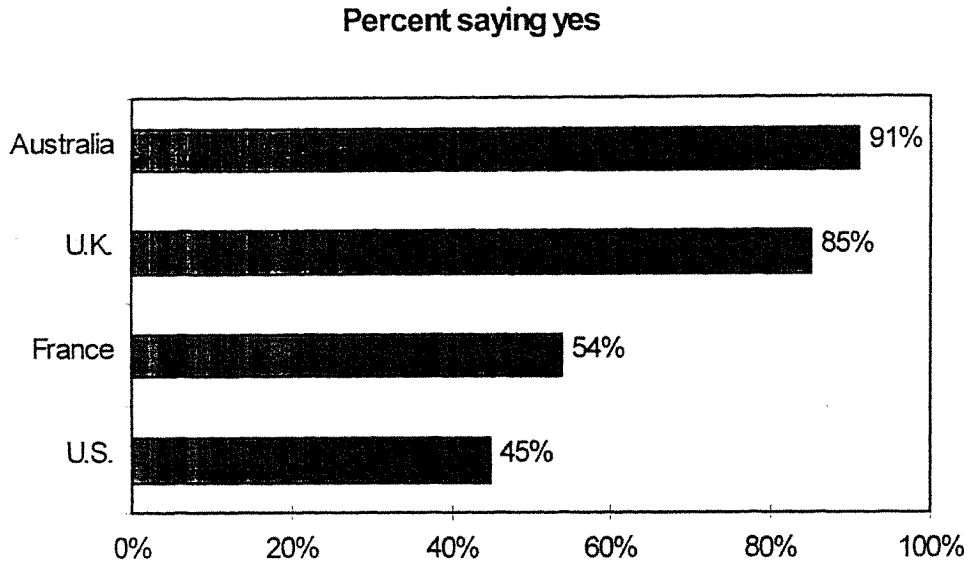
- have greater resources
- have economies of scale and professional expertise
- have greater incentives
- trade more frequently

IMPLICATIONS FOR CORPORATE GOVERNANCE

- Theory
- Evidence
- Views on corporate governance
 - Russell Reynolds study
 - Centre for Corporate Law study

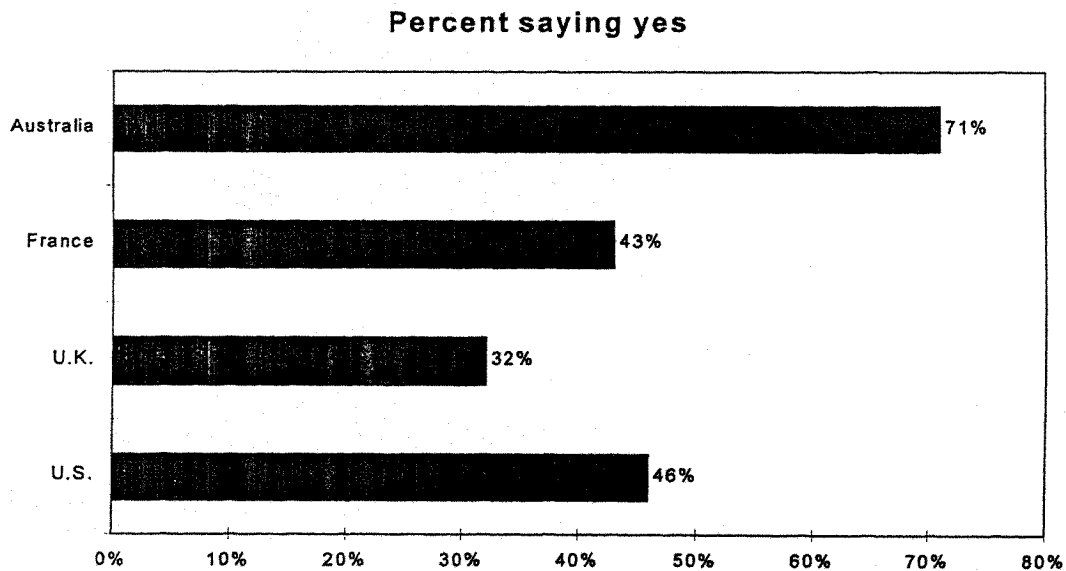
1998 Russell Reynolds Associates International Survey of Institutional Investors

Chairman & CEO: two different jobs



1998 Russell Reynolds Associates International Survey of International Investors

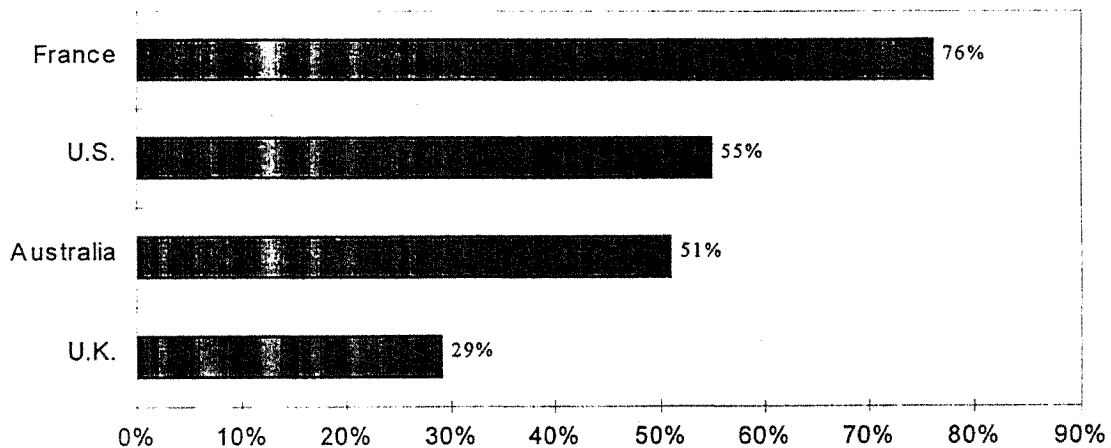
Would you sacrifice high returns to get good corporate governance?



**1998 Russell Reynolds Associates
International Survey of International Investors**

**Extremely or very reluctant to invest in a foreign country
with poor corporate governance practices**

Percent saying yes



CENTRE FOR CORPORATE LAW STUDY

- Views of institutional investors on corporate governance
- Forms of involvement in corporate governance
 - voting
 - specific instances of intervention
- Barriers to activism
 - legal barriers
 - economic barriers

SOURCES

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INSTITUTIONAL INVESTORS
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INSTITUTIONAL INVESTORS AND CORPORATE GOVERNANCE*

I. Introduction

The end of the 1980s takeovers boom heralded the rise of the institutional investor as a significant player in corporate governance. Before then, their role in corporate governance had been confined largely to tendering – or not tendering – their shares to hostile takeover bidders. Since the late 1980s, however, institutional shareholders have moved to the front page through intervening to shake up the boards of underperforming companies; producing and promoting best-practice guidelines covering board structure and composition, executive remuneration, and a range of other matters; and actively participating in debates about corporate law reform. Indeed, the chairman of the Australian Securities and Investments Commission (ASIC) has expressed the view that shareholder action is “central to the proper functioning of our capital markets” (Callick 1994).

This paper highlights the role played by institutional investors in corporate governance in Australia. It details the findings of an interview study conducted in late 1997 and early 1998. Representatives of twelve institutional investors were interviewed about their role in corporate governance. Issues covered included their exercise of voting rights; their involvement in behind-the-scenes activism; and their views on a range of key corporate governance issues such as board structure and composition. Several of the issues covered in the interviews have been addressed in guidelines produced by bodies like the Australian Investment Managers’ Association (AIMA) (which is now part of the Investment and Financial Services Association (IFSA)), the Bosch Committee, and Britain’s Cadbury, Greenbury and Hampel Committees.

Section II of the paper provides a backdrop. It gives an overview of the growth – and implications of the growth – in institutional shareholdings. Section III then describes the institutions interviewed. The findings of the interviews are presented in Sections IV, V and VI. Section VII is the conclusion.

Section IV reports the institutions’ views on several major corporate governance issues. A significant finding of the study is that individual institutions do not always agree with key guidelines – even those published by their own industry association. The point should not be overstated, however, because:

- it would be a rare industry association that could claim 100 per cent member support for all of its policies; and
- AIMA’s key guidelines enjoyed the support of a majority of the institutions interviewed.

The institutions were also asked to describe the ways in which they have become involved in corporate governance at companies in which they hold shares (“investee

* Funding for this research was provided by the Australian Research Council.

companies”). The findings are reported in Section V. Section VI documents the institutions’ views on a range of possible barriers – legal, economic and practical – to institutional investor activism. While acknowledging the existence of several barriers, most institutions took a pragmatic view. They considered that, if an issue is serious enough, shareholder activism is still a major option despite any regulatory and economic disincentives.

II. The rise in institutional shareholdings

The growth in institutional shareholdings in Australia in recent decades mirrors even greater growth elsewhere – particularly in the United Kingdom and the United States. As at 1994/95, institutions held 60 per cent of listed domestic equities in the UK, 52 per cent in the US and in the region of 50 per cent in Australia (Stapledon 1996b, 1998a; AIMA 1997). The lower figure in Australia reflects the prevalence of large founding family and intercorporate stakes in almost half of Australia's large and medium-sized listed companies (Stapledon 1996b).¹ However, the combination of compulsory superannuation² and the relative long-term outperformance of equities compared to bonds³ should see a continued increase in the level of institutional shareholdings in listed Australian companies.

But why is the growth in institutional share ownership important? Who owned the bulk of listed equities before the institutions came along?

Aggregate share ownership statistics for listed Australian companies have only existed since the early 1990s. However, the UK's Central Statistical Office (1995) has figures on ownership of listed UK equities going back to the early 1960s. In 1963, individuals held 54 per cent of listed UK equities. This had fallen to just 20 per cent by 1994. In contrast, the holdings of institutions increased from 29 per cent in 1963 to 60 per cent in 1994.

A considerable majority of the shares held by individuals are held in relatively small parcels.⁴ Therefore, in the early 1960s – and before – it is probably fair to say that the Berle and Means (1967) conception of a public company held true for many listed UK companies. Berle and Means, who studied the shareholdings of listed US companies in the late 1920s and early 1930s, found the typical company to have a mass of diffuse small shareholders (with directors and senior management owning only a very small portion of the shares). A small shareholder in a large company stands to gain only a small reward for any efforts at monitoring the board and senior management, because the³ benefits from monitoring are shared among all the (many) shareholders. But monitoring is costly, and therefore most

¹ Examples include the Murdoch interests' 31 per cent stake in News Corporation Ltd; AXA's 51 per cent stake in National Mutual Holdings Ltd; Malaysia Mining Corp's 47 per cent stake in Ashton Mining Ltd; Paul Ramsay's 44 per cent stake in Prime Television Ltd; and Rio Tinto's 67 per cent stake in Comalco Ltd. The institutional shareholding figure of approximately 50 per cent for listed Australian companies is a combination of the holdings of Australia-based institutions (33 per cent) and an estimate of the portion of the total overseas holdings (32 per cent) accounted for by overseas-based institutions.

² The Federal Government's Retirement Income Modelling Task Force projects that the assets of Australian superannuation funds will grow in value from \$250 billion in 1996 to between \$1,494 billion and \$1,825 billion in 2020 – an increase in real terms of between 190 and 250 per cent: Financial System Inquiry (1997) p 128.

³ Taking 10 year rolling returns between 1900 and 1993, Australian shares returned on average 11.9 per cent per annum, compared with the average return on bonds of 5.0 per cent per annum and the average inflation rate of 4.6 per cent per annum: Mouatt (1994).

⁴ In the UK in 1994, nearly two-thirds of the shares held by individuals were in holdings of less than £100,000 value, and just over a fifth of them were in holdings of less than £5,000 value: Central Statistical Office (1995) p 8.

small shareholders are “rationally apathetic”. The chief concern of Berle and Means was that “Where ownership is sufficiently sub-divided, the management can ... become a self-perpetuating body even though its share in the ownership is negligible” (Berle and Means 1967, p 82). This gave rise to the famous expression “a separation of ownership and control”: ownership resting with the myriad of small shareholders, and control residing in senior management.

It is not surprising, therefore, that the rise in institutional shareholdings – with an accompanying increase in the concentration of shareholdings – has led many commentators optimistically to predict the end of the separation of ownership and control.⁵ In the US, this optimism has normally been qualified by a reference to a plethora of legal barriers to institutional investor activism that would need to be addressed if institutions are to become a true force as monitors of corporate managements.⁶ Some commentators have also highlighted a range of economic barriers that arguably restrict the institutions’ level of involvement in corporate governance even more than the legal barriers.⁷ The practical significance of legal and economic barriers to activism in Australia was one of the key issues raised in the interviews. The findings are discussed in Section VI.

Has the rise in institutional shareholdings had a measurable impact on corporate performance so far? An Australian answer awaits the results of research being conducted by the Centre for Corporate Law and Securities Regulation, and the Department of Accounting and Finance, at the University of Melbourne.⁸ As far as the US is concerned, Black (1998) reviewed the empirical studies which have tried to determine whether institutional investors have had any impact on the performance of listed US companies. The studies summarised by Black have, collectively, addressed these five issues:

- whether companies with a high level of institutional ownership, and therefore the possibility for accompanying monitoring, outperform companies with lower institutional ownership;
- whether institutional activism targeted at particular companies affects performance;
- whether there are abnormal share price returns around the date when a formal shareholder proposal is announced, or the date when a company announces acquiescence to an informal proposal;
- whether discrete corporate events (for example, subsequent CEO turnover or corporate restructuring) occur more frequently at companies that have been targeted by institutions for governance efforts; and

⁵ See, for example, Black (1990); Barnard (1991).

⁶ See, for example, Black (1990); Grundfest (1990); Roe (1994); Sametz (1995).

⁷ See, for example, Coffee (1991, 1994, 1997); Rock (1991); Stapledon (1996a, 1996b).

⁸ The research project, titled “The Impact of Institutional Investors on Capital Markets and Corporate Performance”, is being funded by an Australian Research Council Collaborative Grant, in conjunction with IFSA. The Chief Investigators for the project are Professor Kevin Davis, Professor Ian Ramsay and Dr Geof Stapledon.

- whether a regulatory change that increases the potential effectiveness of shareholder activism results in abnormal share price returns for companies that had been targeted before the regulatory change.

Black's review found that the studies produced mixed results – some indicate that institutional investor activism has a positive impact on corporate performance, some indicate that it has a negative impact, and some show no significant impact at all. Importantly, however, all of the studies focus on “visible” activism.⁹ Behind-the-scenes (or “invisible”) activism also occurs in the US, but by definition its impact is impossible to study in the ways summarised above. Yet it is entirely plausible that invisible activism is more effective than visible activism: UK institutions have emphasised that their most effective interventions have occurred away from the public spotlight.¹⁰ The institutions interviewed in the present study were asked about their involvement in activism – visible and invisible – and the findings are reported in Section V.

⁹ Recent studies (which also focus on visible activism) include Choi (1997); Gillan and Starks (1998); Rajgopal and Venkatachalam (1998); see also Ramsay and Blair (1993) pp 182-183.

¹⁰ See the findings of the interview studies reported in Black and Coffee (1994) pp 2041-2055; Gaved (1995) pp 84-92; Holland (1996) pp 135-147; Stapledon (1996a) pp 117-131.

III. Background to the institutions interviewed

Twelve major institutional investors were interviewed for this project. Each of the institutions was a member of AIMA, and is now a member of IFSA.¹¹ As at 31 December 1997, collectively the 12 institutions had \$150,946 million in assets under management. This represented 35 per cent of the total funds under management by AIMA's 57 members at that date.

The interviews were conducted in the latter half of 1997 and early 1998. In each case, the person responsible for oversight of corporate governance issues was sought for interview.¹² Depending on the size and internal structure of the particular institutional investor, this typically was the Director or Manager of Investments/Equities.

Five of the 12 institutions interviewed were fund management arms of insurance-based financial services groups. Another five were fund management arms of banking or investment banking groups. Of the remaining two, one was an independent fund management firm and the other was a large corporate superannuation fund. This superannuation fund used external fund managers. The other 11 institutions managed either a mixture of internal and external (client) funds, entirely external client funds, or (in one case) entirely internal funds. Of those 11, nine institutions described their management style as active and the other two described their management style as both active and passive, depending on the particular client mandate. Active managers are also known as "stock pickers" – they aim to achieve better returns than the market through active stock selection and trading. Passive managers are also known as "indexers" – they aim to match the performance of a particular basket of stocks, such as the All Ordinaries Index.

In determining the asset allocation within their portfolios, all institutions stressed the importance of their internal analysts' research. This was given more weighting than other sources of information such as broker research, financial data and annual reports. Internal research included analysts meeting with senior management of prospective investee companies.

Six institutions described their goal as "total return", being the combined impact of capital gain from investments, and income derived from those investments. Three institutions described their aim as "capital gain", and one described its aim as "income return". The other two institutions in each case said the primary aim depended on the particular client whose funds were being managed.

¹¹ On 1 January 1998, AIMA merged with two other industry associations – the Investment Funds Association and the Life, Investment and Superannuation Association – to form IFSA.

¹² This reflects the approach taken in other interview studies. Mirador (1994) and Stapledon (1996a) conducted earlier Australian studies (in 1994). UK studies have been conducted by Black and Coffee (1994), Gaved (1995), Holland (1995, 1996, 1998) and Stapledon (1996a). O'Barr and Conley (1992) conducted interviews with large US pension funds.

Generally the institutions invested with a medium-to-long-term time horizon. Twelve months was considered medium term, anything longer was considered long term. One institution said it would like to be able to utilise ten-year time horizons.¹³

Asset allocation amongst the institutions was similar. At the time the interviews were conducted, each institution had approximately 40 per cent of total funds invested in Australian equities, with approximately 15 per cent of total funds invested in international equities. The balance was held in fixed interest (government bonds, etc), cash and property.

¹³ The alleged “short-termism” of institutions has been much debated in the UK and the US: see, for example, Marsh (1990); National Association of Pension Funds (1990); Stapledon (1996a) pp 212-237.

IV. Views on key corporate governance issues

The institutions were asked their views on a range of issues which have been at the heart of the corporate governance debate in Australia and overseas in recent years. Most of these key issues are addressed in best practice guidelines, like:

- the AIMA Blue Book guidelines (AIMA 1997);
- the guidelines produced by the Bosch Committee (1995); and
- the guidelines contained in the Combined Code in the London Stock Exchange Listing Rules.¹⁴

Of the three sets of guidelines, those in the London Combined Code have the most teeth. Every UK company listed on the London Stock Exchange must state in its annual report whether it complied with the Code provisions during the reporting period and, where it did not do so, why it did not do so.¹⁵ In contrast, the ASX's corporate governance listing rule leaves it to each company to decide which corporate governance practices to discuss in its annual report, and what to say about them.¹⁶ Extraneous guidelines therefore assume a greater importance in Australia. Given the growth in institutional shareholdings, the AIMA Blue Book guidelines could be expected to have particular significance in Australia – bearing in mind that all of the major institutions were members of AIMA (and are now members of its successor, IFSA). As mentioned earlier, however, the present interview study includes some interesting findings on the extent to which best practice guidelines actually reflect the views of major investors.

A. Composition of the board

(1) Independent directors

What the guidelines say ...	
AIMA / IFSA	<ul style="list-style-type: none"> • a majority of board members should be independent non-executive directors
Bosch	<ul style="list-style-type: none"> • a majority of board members should be non-executive directors • at least one-third of board members should be independent non-executive directors
London Combined Code	<ul style="list-style-type: none"> • at least one-third of board members should be non-executive directors • a majority of the non-executive directors should be independent

¹⁴ The Combined Code was derived by the Hampel Committee (1998) from (i) its own report; (ii) the report of the Cadbury Committee (1992); and (iii) the report of the Greenbury Committee (1995).

¹⁵ London Stock Exchange, Listing Rule 12.43A(b).

¹⁶ ASX, Listing Rule 4.10.3.

An independent non-executive director is a director who is independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgment.¹⁷

Nine of the 12 institutions considered it important that an investee company have some independent directors on its board. Those nine institutions all expressed a preference for the board to have a majority of independent directors – which reflects the AIMA guideline.

The stress placed did vary. Six institutions said it was “very important” for a board to include some independent directors. One of those said it had “great discomfort in investing in companies where there are no non-executive directors”. Another said there was “not a lot of value in having executive directors on the board. What finance director is going to stand up to the CEO at the board table?” This is an interesting comment given Henry Bosch’s recent prediction that “by 2010 the typical board will only have one executive on it – the CEO” (Bolt 1998).

Another institution stated that independence was important, but in itself not enough: “We like to see a united board with a good proportion of independent directors, but we also like to see directors with good qualifications.” Another said: “The importance of having independent directors varies with the type of company and the type of industry in which the company operates. If an independent director can add value, skills and experience, then we want him on the board. But as a token, an independent who is not value creating, possibly value destroying, we’d have to analyse that.”

Three institutions said having independent directors was not a major issue for them. Two of these said that, while their stated preference was to have independent directors, it was not a major decision-making factor.

¹⁷ This is the definition in the London Combined Code, para A.3.2. The AIMA Blue Book contains a more specific definition (AIMA 1997, para 3.2): “An independent director is a director who is not a member of management (a non-executive director) and who:

- is not a substantial shareholder of the company or an officer of or otherwise associated directly or indirectly with a substantial shareholder of the company;
- has not within the last three years been employed in an executive capacity by the company or another group member or been a director after ceasing to hold any such employment;
- is not a principal of a professional adviser to the company or another group member;
- is not a significant supplier or customer of the company or another group member or an officer of or otherwise associated directly or indirectly with a significant supplier or customer;
- has no significant contractual relationship with the company or another group member other than as a director of the company; and
- is free from any interest and any business or other relationship which could, or could reasonably be perceived to, materially interfere with the director’s ability to act in the best interests of the company.”

(2) Role of the chairperson

What the guidelines say ...	
AIMA / IFSA	<ul style="list-style-type: none"> • chairperson should be an independent non-executive director • if not, the independent non-executives should appoint one of their number to be “lead director”
Bosch	<ul style="list-style-type: none"> • except in special circumstances, the roles of chairperson and CEO should be separate • where the roles are combined, appointment of an independent non-executive director as deputy chairperson should be considered
London Combined Code	<ul style="list-style-type: none"> • a decision to combine the posts of chairperson and CEO in one person should be publicly justified • in any case, there should be a “senior independent director” (a recognised senior member of the independent non-executive directors – separate from the chairperson)

Institutions were asked to explain what they perceived as the role of the chairperson of the board, and whether they considered it important that the positions of chairperson and chief executive officer (CEO) be occupied by different persons.

All 12 institutions said it was important that the chairperson and the CEO be different persons. The prime concern here was that of conflict of interest between the two roles. One institution said: “The board needs to look to long-term wealth creation; the CEO might only be on a three-year contract.” Another said: “They have separate responsibilities. One is operational, the other is governmental.”

Thus, the role of the chairperson was seen to provide some independence from senior management. Three institutions also mentioned the role of the chairperson as that of representing shareholders and providing shareholder access to the board if there were concerns with management.

(3) Nominee directors

Only two institutions favoured institutional investors having nominee directors on boards of investee companies. It was generally believed by the other 10 that having nominee directors would present problems with potential conflicts of interest and the insider trading laws.¹⁸ Two institutions also said that their core business was making investment decisions – not running companies – and that having nominee directors could “reduce the efficiency of fund managers if they are tied up with various boards in terms of independence and it can compromise them”.

Of the two institutions which supported nominee directors, one said it would not generally support them but, “during a time of crisis, an interim appointment of a nominee might be acceptable”. The other said: “Institutions have been particularly critical of

¹⁸ In regard to the insider trading laws, see Section VI.

corporate governance over the last 20 years. A nominee would ensure that that side of the company operated properly.”

B. Board committees

(1) Nomination committee

What the guidelines say ...	
AIMA / IFSA	<ul style="list-style-type: none"> • board should appoint a nomination committee (to make recommendations to the full board) • committee should be chaired by an independent non-executive director • a majority of the committee members should be independent non-executive directors
Bosch	<ul style="list-style-type: none"> • board should appoint a nomination committee (to make recommendations to the full board) • committee should be chaired by an independent non-executive director • a majority of the committee members should be independent non-executive directors • where the company or the board is small, an alternative may be appropriate¹⁹
London Combined Code	<ul style="list-style-type: none"> • unless the board is small, a nomination committee should be established (to make recommendations to the full board) • committee should be chaired by the board chairperson or a non-executive director • a majority of the committee members should be non-executive directors

Institutions were asked whether they thought nomination committees responsible for proposing new directors should be compulsory for publicly listed companies.

Eight said that they should be compulsory, though three qualified this by saying it did depend on the size of the company. Thus one institution said: “For bigger companies, a nomination committee makes sense; for smaller companies, the whole board could do it.” Another added that not only should nomination committees be compulsory, they should be comprised predominantly of independent directors. Another institution said nomination committees should be comprised of “directors [who know] exactly why they’ve been appointed, what is expected from them, and with a review process after a year”.

Four institutions said nomination committees should not be compulsory. One said that it was “awkward as they tend to bring similar people to the board”. Another said: “One thing we have been involved in as a shareholder is actually helping boards find relevant persons.

¹⁹ Here, the Committee says that “consideration should be given to alternative ways of demonstrating to shareholders that the process of director specification and selection is objective. This may involve the use of external professional advisers and additional disclosures”: Bosch Committee (1995) p 23.

We are approached by companies to suggest individuals who may be appropriate as non-executive directors. This is a role institutions should become more involved in.”

The fact that one-third of the interviewees were not enthusiastic about nomination committees might partly explain why the incidence of these committees has been considerably lower among large listed Australian companies than among large listed UK companies. Almost three-quarters of the Top 100 listed UK companies had a nomination committee as at 1994, compared to only 19 per cent of the Top 100 listed Australian companies a year later (Stapledon and Lawrence 1996).

(2) Remuneration committee

What the guidelines say ...	
AIMA / IFSA	<ul style="list-style-type: none"> • board should appoint a remuneration committee (to advise the full board) • committee should be chaired by an independent non-executive director • a majority of the committee members should be independent non-executive directors
Bosch	<ul style="list-style-type: none"> • board should appoint a remuneration committee (to report to, and make proposals to, the full board) • no recommendation on committee chairperson • a majority of the committee members should be independent non-executive directors • where the company or the board is small, an alternative may be appropriate²⁰
London Combined Code	<ul style="list-style-type: none"> • board should appoint a remuneration committee (to make recommendations to the full board on the company's framework of executive remuneration; and to determine on behalf of the full board the specific remuneration package for each executive director) • all committee members (including the committee chairperson) should be independent non-executive directors

Seven institutions supported a requirement that all boards have remuneration committees with a majority of independent non-executive directors. One institution said: “This would allow some objectivity and peer group comparison and allow the tapping of appropriate views within the industry.” The other five institutions supported remuneration committees for larger companies, but not for small companies: “Once you get away from the top thirty or fifty companies, it becomes a burden. We prefer compliance with best practice rather than a certain structure to implement it.” Similarly, another institution said: “It depends on the business. With a small company, you can't have [directors] sitting around in meetings all day. With BHP, it's a different organisational structure.”

²⁰ Here, the Committee says that “consideration should be given to alternative means of demonstrating to shareholders the objective basis of remuneration and related party transactions. This may involve the use of professional advice and additional disclosure”: Bosch Committee (1995) p 31.

C. Assessing board performance

Institutions were asked whether they monitored the performance of individual directors as well as the board as a whole.

All the institutions said it was generally too difficult to monitor the performance of individual directors. One institution said this amounted to a “new science. We don’t have a robust enough database on board members. The danger is of partial analysis. It gets back to the need to form an ongoing dialogue with the company.” Three also mentioned the difficulty of assessing individual directors since the institutions were not actually attending board meetings themselves.

However, one institution said it did monitor individual directors, “particularly companies going through a change in the structure of the board or management. We will intervene to prevent the re-election of directors when they are associated with past events.”

Another said it did “notice the performance of some directors if people get associated with companies that have not done well. You get them on a board if you can’t find anyone else. It’s a sign of trouble.” Similarly, another institution said: “We expect the board to make changes when appropriate. There are certain individuals we would not want on a board: those associated with corporate failures or misbehaviour.”

D. Director and executive remuneration

(1) Remuneration of the CEO and senior management

What the guidelines say ...	
AIMA / IFSA	<ul style="list-style-type: none"> • board should disclose in annual report its policies on, and the quantum and components of, remuneration for all directors and each of the 5 highest-paid executives • in relation to executive share option schemes:²¹ <ul style="list-style-type: none"> ◊ responsibility for their design and implementation should belong to the remuneration committee ◊ they should be designed around encouraging future performance, rather than to reward executives for past performance ◊ linking schemes to total return (ie share price growth plus dividends) is preferred
Bosch	<ul style="list-style-type: none"> • the remuneration arrangements for the CEO and other senior executives should be a function of the remuneration committee
London Combined Code	<ul style="list-style-type: none"> • board should disclose in annual report the company's policy on executive directors' remuneration, and comprehensive details of the remuneration of each director;²² the board should consider each year whether the AGM should be invited to approve the remuneration policy • the performance-related elements of remuneration should form a significant proportion of the total remuneration package of executive directors • in relation to annual bonuses: <ul style="list-style-type: none"> ◊ performance conditions should be relevant, stretching and designed to enhance the business ◊ upper limits should always be considered • in relation to long-term incentive schemes (including share option schemes): <ul style="list-style-type: none"> ◊ payouts or grants should be subject to challenging performance criteria reflecting the company's objectives ◊ consideration should be given to criteria which reflect the company's performance relative to a group of comparator companies in some key variables such as total shareholder return

All but one institution advocated performance-based remuneration schemes for executive directors and senior management, though opinions varied as to what hurdle rates should be set. Concern was more with the hurdle rates rather than the level of remuneration.

One institution said: "Bad [remuneration] schemes are so obvious, they are symptomatic of poor management. They signal to their own people that certain people are getting a free lunch; they signal to potential investors that the company is not well managed. We like a

²¹ These guidelines are contained in AIMA (1994).

²² This has been a London Stock Exchange listing requirement since 1996.

remuneration policy linked to shareholder value. We have recently objected to ‘in the money’ option schemes where the hurdle rates have been a joke. We favour schemes based on total return.”²³

Another said: “We have concerns about excessive remuneration and the hurdle rates for option schemes. The financial benefit of those schemes should only occur if there is significant improvement in either operational or share price performance. Generally we prefer a share price barometer, relative to the market, over a medium-to-long term, five to ten years. The issue is having enough disclosure to make a judgment about what is appropriate, rather than quantum.”

Similarly, another institution said: “We expect schemes to be generous. If not, they’re not adequate. Performance-related pay is all the go at the moment and that’s the way it should be. It has to be genuine performance-related pay; if the company is performing, they should be rewarded; if not, they shouldn’t.”

Another institution stressed that remuneration schemes should be tied to performance indicators other than share price: “Share price is a reflection of the overall strength of the market rather than the skill of the particular manager running the company. We prefer schemes tied to earnings or dividend stream.”

The interviews were conducted before the Company Law Review Act was passed. That Act significantly strengthened the disclosure requirements for directors’ and senior executives’ remuneration – in line with the AIMA Blue Book guideline summarised in the above table.²⁴ Four institutions raised the issue of disclosure of remuneration schemes. One said: “Disclosure should be required of those who have a decision-making capacity which influences the future of the company. We support the US and UK standards for disclosure in the annual report.” Another institution commented: “The annual report only gives the range of the terms of the remuneration; it does not give the guidelines that were used”; while another said: “It would be nice if you could actually identify who each of [the directors] was from the schedule that is in the annual accounts.” These concerns are likely to have been addressed by the Company Law Review Act changes.

One institution thought that directors should not have performance-based remuneration: “We prefer directors to get a straight cash salary. We don’t like any financial incentives for directors. We are happy for executive directors to be given shares in lieu of directors’ fees

²³ Total return refers to share price growth plus dividends.

²⁴ See now Corporations Law, s 300A. AIMA (and subsequently IFSA) lobbied hard for this reform: see Parliamentary Joint Committee on Corporations and Securities (1996) paras 2.113-2.115; (1998) paras 1.36, 1.53-1.54. It was introduced as one of the last-minute changes to the Company Law Review Bill, without Government support, in order to have the legislation operational on 1 July 1998 (Main 1998). The Government subsequently referred the matter to the Parliamentary Joint Committee for examination (Main 1998).

and strongly encourage directors to be shareholders. But it should be either cash or shares. If directors are doing what they should be doing, they should be paid well.”

(2) Remuneration of non-executive directors

What the guidelines say ...	
AIMA / IFSA	<ul style="list-style-type: none"> • board should establish, and disclose in annual report, a policy to encourage non-executive directors to invest their own capital in the company or to acquire shares from allocation of a portion of their fees • non-executive directors should not participate in a share option scheme designed for executives
Bosch	<ul style="list-style-type: none"> • the remuneration of non-executive directors, including all benefits such as options, rights and pensions, should be fully disclosed to shareholders and approved by them • the level of remuneration should reasonably reflect the responsibilities and risks of being an effective director
London Combined Code	<ul style="list-style-type: none"> • the board or, where required by the company’s constitution, the shareholders should determine the remuneration of non-executive directors

Institutions were asked whether non-executive directors should also have performance-based remuneration schemes or should be paid a pre-determined fee.

In line with the AIMA Blue Book guidelines, nine institutions objected to performance-based remuneration for non-executive directors. The principal basis of the objection was the potential conflict of interest and the compromise of their independence, and their role as monitors of management. Thus, one institution said: “The role of non-executive directors is to control risk and, if you give too many performance-based schemes, they might disregard the risk.”

Another said: “The negative [aspect of performance-based remuneration] is the potential for short-termism. Also, directors should be sufficiently rewarded in fees and, if they are shareholders, they pick up their reward the same way as everyone else.” Another said non-executive directors “should own shares in the company. We have no problems with fees being paid in the form of shares but, other than that, they should receive a fixed fee for a fixed job.”

One institution said there should be a minimum performance standard such as the number of meetings attended, and that directors should be required to undergo sufficient training so that they understand the needs of the business operated by the company.

V. Forms of involvement in corporate governance

A. Voting

Perhaps the easiest way an institution can involve itself in the governance of a company in which it has invested its clients' funds is by actively voting on resolutions put to the general meeting.

(1) Delegation by clients of their voting rights

Where an institution manages some of its clients' assets in a pooled fund – that is, a unit trust or a pooled superannuation trust – the institution has power to exercise the voting rights attached to equity investments of the pooled fund (Stapledon 1998b). The clients are unitholders in the pooled fund and cannot individually give voting directions to the institution managing the fund.

The situation is completely different in the case of a “discrete client” – that is, a client whose assets are managed as a separate or discrete portfolio (rather than collectively with those of other clients in a pooled fund). The voting rights attached to equity investments of a discrete client belong to that client unless it has authorised the fund manager to exercise the voting rights on its behalf. Often a discrete client will be the trustee of a large superannuation fund. There has been some debate in the past as to whether superannuation trustees can properly give this voting authorisation (Stapledon 1998b), but all institutions interviewed assumed they were properly authorised.

Each institution was asked whether it used the *AIMA Standard Investment Management Agreement*. Under clause 12 of the AIMA standard agreement, the client (commonly a superannuation fund trustee) authorises the fund manager to exercise the voting rights attached to shares forming part of the investment portfolio. The fund manager may vote or decline to vote as it sees fit, subject to any direction from the client. Alternatively, if the institution did not use the AIMA standard agreement, did its own typical investment management agreement contain a clause similar to clause 12?

Ten institutions said they generally did use the AIMA standard agreement. Of the other two, one institution did not manage external clients' money and the other institution was a superannuation fund which employed external fund managers but always retained the voting rights.

Of the ten institutions which did use the AIMA standard agreement, nine said they did include clause 12 and were normally given the voting rights attached to shares in their portfolios, though some did say that a few discrete clients retained the voting rights in specific instances. Only two institutions unequivocally said they had no clients at all who retained any voting rights.

Where clients had retained the voting rights, these had related to specific issues and had been rarely exercised. There was a slight perception amongst those interviewed that public-sector clients were more likely to want to retain their voting rights rather than private-sector clients.

(2) Exercise of vote versus abstention

What the guidelines say ...	
AIMA / IFSA	<ul style="list-style-type: none"> investment managers should vote on all material issues at all Australian company meetings where they have the voting authority and responsibility to do so investment managers should have a written policy on the exercising of proxy votes that is approved by their board, and formal internal procedures to ensure that that policy is applied consistently
Bosch	<ul style="list-style-type: none"> shareholders should have made a sufficient analysis to vote in an informed manner on all issues raised at general meetings
London Combined Code	<ul style="list-style-type: none"> institutional shareholders have a responsibility to make considered use of their votes

Seven of the institutions said they voted on all matters. Another said its policy was to vote, though on rare occasions it would make a conscious decision to abstain. The other institutions said it was their policy to abstain unless the issue was something to which they strongly objected. The issue most likely to raise objection was executive remuneration schemes; otherwise they would not vote on routine or mechanical matters. Thus, one institution's policy was to abstain unless its (external) investment manager insisted that voting was essential on the matter in question – in which case it would vote according to the investment manager's recommendation.

One institution which managed a mix of active and passive (or “index”) funds noted that it never exercised the votes attached to shares in passive funds. This is not surprising, because the fees charged for passive management are considerably lower than those charged for active management – with the result that managers of predominantly passive funds will rationally take a minimalist approach to corporate governance (Coffee 1997; Rock 1991; Stapledon 1996b).

Another institution stated that companies sometimes called them to “get our support, and, if we agree, we're happy to give our proxy in favour of the chair”.

Where there was a general policy to exercise the vote, there were still circumstances in which an institution might consciously choose to abstain. Generally this was on issues considered non-controversial and which did not impact or damage the valuation of the business. However, one institution did state that it might abstain to “keep rapport with the management”. This raises the issue of conflict of interest – which is addressed later in the

paper.²⁵ Another institution said: “There are degrees of aversion to particular proposals, and if you’re not sure to vote for or against, it’s best to abstain.”

(3) Informing client on voting

What the guidelines say ...	
AIMA / IFSA	<ul style="list-style-type: none"> the investment manager should report back to the client when votes are cast (including abstentions) on investments owned by the client – as part of the regular reporting process to the client
Bosch	<ul style="list-style-type: none"> no recommendations
London Combined Code	<ul style="list-style-type: none"> institutional shareholders should, on request, make available to their clients information on the proportion of resolutions on which votes were cast and proxies lodged

Seven of the institutions said they had one or more clients who required that they be consulted prior to the institution exercising its vote. Three of those institutions said clients wanted to be informed on major issues only, such as remuneration schemes or the “sort of issues that make the papers”. Another institution said that generally it did not consult clients, but “there may be some who wish to be consulted on certain issues. We use our discretion. If there were sensitive issues, we would consult.”

Another institution said it was required to consult the client whenever there was a potential conflict of interest.²⁶ Conversely, one institution which never consulted the client prior to voting said it would not favour any requirement to consult: “We ask for the authority to vote or else you can do your own.”

Recording of votes and reporting back to clients does occur, even when not specifically required by the client. Two institutions produced an annual report; three institutions produced quarterly reports; and another two produced monthly reports. Two others said they had the systems in place to produce regular reports, but had no clients who had asked for them. Two institutions said they did not produce reports unless required under the mandate with the client; one said it had clients who required six-monthly updates.

Ten institutions said they did not support making it a legal requirement that they report back to the client on how votes had been exercised. It was felt that clients were not particularly interested: “Clients don’t really care, they care about performance and not much else.” Another noted the “administrative burden and difficulty of custodians determining which parcel of stocks belong to whom in relation to voting”.

Another institution said that, while it did not support making reporting of voting a legal requirement, “it is important if you’re voting on someone’s behalf to tell them what you’ve

²⁵ See Section VI.

²⁶ For further discussion of conflicts of interest, see Section VI.

done. Clients, fund managers and trustees are still coming to grips with their roles.” According to this institution, reporting is part of the service to the client, and it is not necessary to make it a legal requirement.

Two institutions did support a requirement for regular reporting: “The client should be fully informed of what actions their managers are taking on their behalf.”

(4) Voting against management

What the guidelines say ...	
AIMA / IFSA	<ul style="list-style-type: none"> • institutions should support boards by positive use of their voting power unless they have good reasons for doing otherwise
Bosch	<ul style="list-style-type: none"> • no recommendations
London Combined Code	<ul style="list-style-type: none"> • no recommendations

All but one institution had recently voted against a recommendation of the board or senior management of an investee company. One institution did draw the distinction: “We’ve certainly voted against directors. We’d normally vote with management, but that may mean voting against [a recommendation of] directors.”²⁷

One institution which kept up-to-date records noted that, out of 600 votes cast, only 13 had been “no” votes. Another institution said that voting against the management or board was “quite rare. We prefer to contact management, discuss issues and see if they will change their stance. We have voted against the buyback of shares at prices that would have affected the value of the company.”

Ten institutions expressed their preference that contentious matters be resolved behind the scenes rather than put to the vote. A typical comment was: “A lot of work gets done behind the scenes which you would never see, so things quietly disappear off ballot papers simply because there may have been a simple mistake.”

The one institution which could not recall voting against management or the board said: “Not a lot of contentious issues [get put to the vote]. It would be most strange to still be holding a share if you disagree with a board resolution.”

²⁷ For an example of the (rare) situation where there is a major dispute between executive and non-executive directors, and the institutional shareholders side with the executives, see Gourlay (1992).

(5) Informing management or board prior to voting against

What the guidelines say ...	
AIMA / IFSA	<ul style="list-style-type: none"> • if an institution intends to vote against a proposal, it may be appropriate for the institution to contact the company in time for the problem to be considered with a view to achieving a satisfactory solution • where a satisfactory outcome cannot be achieved on an important issue, it may be desirable for a spokesperson to attend the general meeting and explain why the proposal is being opposed
Bosch	<ul style="list-style-type: none"> • where appropriate, reasons for voting against a motion should be made known to the board beforehand
London Combined Code	<ul style="list-style-type: none"> • no recommendations

Of the eleven institutions which had cast a “no” vote, nine had informed the company of the intention to do so beforehand. One of those said it would only inform the company if it had a “meaningful holding – for example, we have over one per cent in a top twenty company”. Another said it depended on the relationship the institution had with the company, “particularly in the case of smaller companies where we’re a major player. In that case, we’d discuss it and they’d be aware of our intentions.” Another said: “Typically, those companies contact us and we let them know what we think.” One institution which did not normally inform the company said it “would not want to telegraph that [the intention to vote ‘no’] to management or the company”.

(6) Compulsory voting

Compulsory voting for institutional investors is a serious issue in the United States and the United Kingdom. Regulations made under the Employee Retirement Income Security Act (ERISA) require US private-sector pension plans to exercise the voting rights attached to their equity investments “on issues that may affect the value of the plan’s investment” (US Department of Labor 1994). And the UK Government made it clear in early 1998 that legislation to mandate voting is a distinct possibility if the level of institutional investor voting does not increase (Martinson 1998).

Three institutions supported the introduction of compulsory voting. One of those did express the “need to do something on the costs of the systems involved; for example, Internet-based proxy lodgment²⁸ or proxy clearing houses” to reduce costs. One institution which did not support compulsory voting did acknowledge that a “higher participation rate in voting could be prima facie beneficial”. Other comments were:

²⁸ Section 250BA of the Corporations Law (which was introduced by the Company Law Review Act 1998) allows – but does not compel – listed companies to specify an “electronic address” for the receipt of proxy forms.

- “You run the risk of a vocal minority running the company, but people have the right to decide to vote or not”;
- “Waste of time if [the issue being voted upon] is of no consequence. We prefer the current situation where we only vote if we feel the need; if it’s an important vote”;
- “Voting should be optional. [Compulsory voting] would entail an administrative cost which would impact on an industry which is aimed at wealth creation and supporting people’s savings. Anything that detracts from that is a cost. It would not add value to the industry”;
- “Our preferred system is for trustees and fund managers to understand the value of a vote and that it is a dereliction of duty if it is not exercised. If voting remains under 30 per cent, maybe [compulsory voting] needs to be introduced”;
- “Some people invest purely to make money; others who feel a genuine sense of ownership and responsibility want to exercise their prerogative to vote. There is no gain from forcing people to vote, especially when the process is so cumbersome”;
- “As a shareholder, you’ve paid your money. It’s totally up to you [to determine] the level of participation you wish to exercise. As an institution, there are times when an abstention is far more powerful than a ‘no’ vote, far more useful, diplomatic and pragmatic”;
- “I’m not sure what the benefits would be. It’s very difficult when people are overseas or have no interest. Do you fine them if they don’t vote?”

(7) Confidential voting

There has been a push by some US institutional investors, in recent years, for voting to be done on a confidential basis (Brancato 1997, p 107). Why?

“Confidential voting prevents management from identifying opponents, pressuring them to change their votes, and sanctioning those who refuse to do so.” (Rock 1991, p 490)

Five institutions thought that voting should be done on a confidential basis, one adding that all voting should be by proxy only. In line with the US thinking, confidential voting was said to alleviate conflicts of interest: “In certain circumstances there is a conflict of interest; the most obvious one is where the fund manager runs the super fund of a company and wants to vote against the management.” The other seven institutions said they were not afraid to have the company know how they had voted. These institutions felt that an open vote had a greater impact in expressing dissatisfaction with the management of the company:

- “We would rather stand up and be counted”,

- “If we were worried about confidentiality, we would attend the meeting and vote by proxy. We’ve never been afraid to exercise our vote and tell management what we don’t like”;
- “At the end of the day, if you are voting ‘no’, you are voting ‘no’ with the full power as fund manager, and the directors need to see that.”

B. Monitoring of investee companies

A system for identifying potential problems within investee companies facilitates the role of an institution in corporate governance. The institutions were asked what monitoring systems they had in place and what sort of regular contact they maintained with investee companies.

(1) Systems for identifying issues

The institutions were asked whether they maintained formal systems for specifically identifying corporate governance problems or whether they were alerted to problems through the normal course of their investment monitoring operations.

Three institutions said they had formal systems. One institution said it held daily meetings in which information was shared amongst all its analysts.

Another – one of the larger institutions – delineated the manner in which an issue would escalate. First, the analyst responsible for monitoring the company would refer the matter to the head of equities. If required, the matter was then referred to the chief investment officer, then the CEO of the funds management division, then the CEO of the parent company, and finally to the chairperson.

In all three institutions, the person responsible for alerting the institution to potential problems was the analyst responsible for monitoring the investee company. Typically, the custodian (as the registered owner of the shares) passed on every company resolution to the analyst who would then make a recommendation on how to vote, giving reasons. Where a controversial matter arose, it was within the analyst’s discretion, using internal guidelines and in two instances the AIMA Blue Book guidelines, as to whether a matter should be referred to a higher level in the institution.

One institution said it used Institutional Shareholder Services (ISS). (ISS is a Sydney-based proxy advisory organisation which monitors the AGM agendas of large and medium-sized listed companies.) With respect to smaller companies which ISS does not monitor, the institution’s own research team was responsible for monitoring the company and making recommendations on voting.

(2) Communication with investee companies

What the guidelines say ...	
AIMA / IFSA	<ul style="list-style-type: none"> investment managers should encourage direct contact with companies including constructive communication with both senior management and board members about performance, corporate governance and other matters affecting shareholders' interests
Bosch	<ul style="list-style-type: none"> institutional shareholders should take an active interest in the governance of companies shareholders should not involve themselves in companies' day-to-day operations
London Combined Code	<ul style="list-style-type: none"> institutional shareholders should be ready, where practicable, to enter into a dialogue with companies based on the mutual understanding of objectives

Nine institutions reported they maintained frequent communications with their investee companies, generally with senior management. Typically, issues such as financial and economic conditions, strategic planning and management issues were addressed at these regular meetings. In five of those instances, it was the responsibility of the analyst to maintain that contact; in three instances it was the responsibility of the portfolio or fund manager; in the remaining instance a "whole team" approach was adopted.

One institution commented that there was "not enough meaningful contact between senior members of investment organisations and non-executive directors. We need more meetings to discuss governance-type issues." Another said: "Our dialogue is quite strong with senior management, but pretty weak with directors. That area needs to be addressed by fund managers generally. Sitting with the independent directors of BHP is something that needs to be brought into the process, but it's difficult because they aren't always around."

Some institutions commented specifically on the frequency of meetings with investee companies. Two institutions reported that they met with investee companies at least twice a year. Another smaller institution said they visited companies approximately once every two years. Meetings between institutions and investee companies also occur at broker-organised lunches and Securities Institute of Australia (SIA) seminars. One institution noted that companies in which it did not hold shares, but which it monitored, would initiate contact with it.

Three institutions said they did not maintain regular contact with their investee companies. However, one of these was the superannuation fund which used external fund managers. It said it held regular meetings with its external fund managers to be kept informed of matters. Another said it held meetings only as issues arose; these might be with the managing director, finance director or chairperson of the investee company – depending on the specific issue. The third said it preferred to judge companies "on how the figures stack up".

C. Specific instances of institutional intervention

Each of the institutions had intervened in an issue of corporate governance in the preceding two years or so. However one institution did not consider action on its part as “intervention”: “We have a close working relationship with those companies we invest in. We focus on the quality of the management, succession planning, strategic direction, audit trail, etc. We would not classify that as intervention but as healthy dialogue.”

Holdings in investee companies in which there had been intervention ranged from 1-2 per cent in Top 100 companies up to a maximum of 18 per cent in a non-Top 100 company. Institutions were asked in what instances they had intervened and the specific matter to which they had objected. Also, they were asked why they had chosen to intervene instead of taking the “Wall Street walk” – that is, selling their holding in the company.

(1) Recent interventions

The most often cited (by five) matter in which the institutions had intervened was the Coles Myer controversy,²⁹ though each of the institutions had its own agenda even within that one dispute and so had differing areas of concern. Objections mentioned included potential conflicts of interest on the Coles Myer board, concern about the Yannon transaction, concern about a proposed dividend re-investment scheme, and the Coles Myer buyback of shares from K-Mart at what was considered an inflated price involving a destruction of shareholder wealth.

Three institutions cited ANI as an example of recent intervention.³⁰ In that instance, objection was voiced to a proposal to restructure the board. One institution held discussions with directors to determine which directors it should support: “We voted for the directors whom we thought appropriate, so some directors missed out as a result of our vote, and everyone else’s. We had some impact on the decision.” Another institution which also intervened at ANI did so because “the previous board had done deals with major shareholders which cost subsequent shareholders considerable amounts of money. The board split on who was responsible; the board changed and management changed.”

Another institution had opposed a proposal that Crown Ltd buy the management rights of Melbourne’s Crown Casino from Hudson Conway Ltd. Another intervention had concerned the hurdle rates for an executive share option scheme; the institution discussed this with the company and other institutions. The scheme was eventually redrafted and approved. Another institution had expressed its concern at the level of benefits being given to non-executive directors of one company, and the lack of clarity of benefits accruing to all employees and directors of another company.

²⁹ See Deans (1995); Hurst (1995); Hurst and Pheasant (1995).

³⁰ See Bartholomeusz (1996); Maley (1996); Ries (1996).

One institution which had substantial shareholdings in two smaller companies (15 per cent and 18 per cent respectively) had intervened in one instance when some directors had proposed to remove other directors and to adopt a policy for taking the company forward with which the institution did not fully agree. In respect of the other company, the institution wanted to reconstitute the board because the existing board had “failed dismally in terms of financial status and profitability”.

(2) Liaison with other institutions

Only two institutions said there had been any liaison with other institutions prior to taking action, though two others said that sometimes informal discussions and meetings did occur. Another institution said that it was “against our interest to communicate to competitors our interest in a company and what we would like to happen. We like to keep that secret.” One institution said it had been approached by other institutions on six occasions in the last two to three years, though no specific instances were recalled. The smaller institutions said they would be surprised if they were approached by the big institutions as they felt the size of their shareholdings to be too insignificant.

(3) Contact with companies

Where there had been institutional intervention, all institutions, with the exception of the superannuation fund which used external fund managers, had been in contact with the company at either the board or senior management level to discuss the issue of concern. Four institutions said they had held discussions with the CEO or managing director; in two of those instances the chairperson had also been contacted.

In two other instances, the finance director and corporate relations manager had been contacted. The other institutions did not specify at what level contact had occurred beyond the broad categorisation of board or senior management.

In six instances, institutions reported they had approached individual directors in the course of their intervention. One added that, “generally with contentious issues, we prefer separate meetings with executive directors and non-executive directors”. Another institution which had approached individual directors said that, in this instance, “there was open warfare on the board, so it was appropriate to speak to the directors individually”.

Within the institutions, it was the analyst responsible for monitoring the company who had responsibility for conducting the discussions although, if the issue escalated, the matter would then be referred to the investment director and, if the matter escalated further, it would then be referred to the managing director or CEO of the institution.

(4) Why intervene?

When asked why they had chosen to intervene rather than just sell their holding in the company, two institutions responded that, given the substantial size of the shareholding (4-5 per cent and 7 per cent respectively), it was not possible to sell such a large holding all at

once and obtain a reasonable price. Another two responded that, at the time, the shares were trading below the company's net tangible asset value, so selling was not a realistic option.

The other institutions felt that resolution of the corporate governance dispute in which they had intervened would lead to a better share price. Several noted the current price of Coles Myer shares, it being much higher than the price at the time of the dispute in late 1995 and early 1996. Thus, one institution said that it would "not necessarily sell stock with poor governance practices if we believe that better returns will result from intervention". Similarly, another institution said it is possible to "be more effective and valuable in the whole corporate governance process if you talk to people rather than just sell".

One institution even considered that a company experiencing difficulties with shareholders in respect of corporate governance issues could represent a good opportunity to buy into that company: "If you employ a value style [of asset management], you buy into companies because they represent good value. You hope that value will be realised and you buy into them cheaply because there's a problem with the company, so it doesn't make sense to sell because of a problem."

For some institutions, selling of shares was considered an option of last resort. Thus, one institution said: "You would sell because you reckoned the thing was so serious that the [share] price wouldn't double perhaps, not because you don't approve of one particular thing." Similarly, another institution said: "If you go through the [dispute resolution] process and elevate [the dispute] to a higher level and still don't get any comfort, and the proposal were to significantly reduce the value of the shares or company value, then we'd sell."

Interestingly, one institution said: "A passive fund manager has a greater need to drive corporate value issues because he doesn't have sell as an option." However, of the various passive fund managers, it is only one managing wholly *internal* funds³¹ that would rationally spend time and resources intervening on a corporate governance issue. A fund manager managing external clients' assets with a passive mandate – and the accompanying low fee – has no real incentive to do anything in the corporate governance field. Why? Because passive managers have a mandate merely to match the performance of the index; they are not expected to outperform the index. And of course they (and their competitors) can meet that expectation very cheaply by being "passive" in every respect – including the extent to which they become involved in corporate governance. The reference to their competitors is important because it highlights the fact that, if one or two institutions spend resources

³¹ For example, an in-house manager of a large superannuation fund. The vast majority of Australian superannuation funds use external fund managers, but in other countries (like the UK) it is not uncommon for several of the largest funds to employ full-time in-house fund managers. However, in recent years there has been a trend towards replacing internal fund managers with external managers: see Cohen (1995).

intervening and (hopefully) increasing the value of a company's shares, their competitors who also hold shares in that company can free-ride on their efforts.³²

³² This point is developed in Section VI.

VI. Barriers to institutional investor activism

Institutions were asked their views on various factors which have been identified as barriers to institutional investor activism in areas of corporate governance.³³ They were asked whether they had found these barriers to be a practical hindrance, and what suggestions for reform they had. These barriers were broadly identified as legal, economic and practical.

A. Legal barriers

(1) Triggering the takeovers provisions

Australia has a statutory system for regulating takeovers and, as Hill (1994, p 606) points out, the provisions “are more than capable of catching conduct not strictly associated with a takeover bid at all”. Part 6.7 of the Corporations Law contains provisions which require anyone who has a “substantial shareholding” (5 per cent or more) in a listed company to notify the company of the substantial shareholding and afterwards of certain changes to the holding. Section 615 of the Corporations Law prohibits a person from acquiring shares in a company if, after the acquisition, any person would be “entitled” to more than 20 per cent of the voting shares in the company. Arguably, the concept of “entitlement” to voting shares is so broad that Part 6.7 and section 615 of the Corporations Law could be breached when several institutional investors act collectively in relation to a company in which each has a shareholding.³⁴

In November 1996 the Australian Securities Commission (ASC) (as it was called at the time) issued for public comment an Issues Paper in which it proposed to grant conditional relief to enable institutions to consult each other and enter an agreement to vote collectively at particular company meetings (ASC 1996). In May 1998 the ASC published a Class Order (ASC 1998b) which grants this conditional relief.³⁵ The interviews took place before the publication of the Class Order, but after the release of the Issues Paper. Therefore, the institutions were asked their views on the proposal contained in the Issues Paper.

Eight institutions said they supported the reform proposed in the ASC Issues Paper. In some cases this support was not unqualified. One institution said: “We support the ASC policy in principle, provided the ASC’s discretion is used appropriately to allow action which was objectively based, not personally motivated. Institutions should ask the hard questions before any problems arise because their role is one of protection of stakeholder interest.” Another said it supported the policy to grant relief, “but not as worded in the Issues Paper. It is very cumbersome. You are required to declare exactly what your conversation was about. It’s ridiculous that shareholders can’t talk to one another.”

³³ These factors are detailed in Stapledon (1996b).

³⁴ For further discussion of this issue, see Stapledon (1996b) pp 159-170.

³⁵ See also the Policy Statement (ASC 1998a) which explains the policy behind the Class Order.

Similarly, another institution said: “There is certainly a lack of clarity about what institutions can do before they breach the takeover provisions. The ASC Issues Paper missed the issues. It said they would grant relief but you had to nominate whom you were seeing and ask for a special arrangement, whereas all we want is the ability to speak to each other. Also, there seemed to be a special offer to institutions that wasn’t there for other shareholders. If the ASC and the Government want institutions to play a semi-regulatory role, we must be allowed to talk to each other without entering contracts.” Another said: “It depends what particular aspects the institutions are interested in. On the corporate governance side, to act in concert seems quite reasonable. If it’s to get around the 20 per cent rule [that is, the takeover threshold], then I would not favour that.”

Objections to the grant of relief to allow institutions to act collectively were based primarily on the potential for abuse: “We have to be careful; it can be substantially abused.” Two institutions pointed out that consultation between institutions was rare in any case because of the competitive nature of the industry: “The biggest barrier to institutions approaching each other is mistrust as competitors in an exceptionally competitive industry.” The smaller institutions said they were not impacted by the law as their holdings were generally too small: “We are too small for it to have ever been an issue for us. We have no problem with people of a similar view voting the same way and discussing it beforehand. It’s more an issue for AMP or National Mutual.”

(2) Insider trading provisions

Institutions were asked whether they had found that the insider trading provisions³⁶ acted as a disincentive to their effective monitoring of investee companies. That is, did a fear of acquiring inside information – and being prohibited from trading the shares until the information was available to the market – restrict the level of monitoring carried out?

One institution stressed, as a preliminary point, that the continuous disclosure requirements now made it “incumbent on a company to disclose the information or do something about it”.

All the institutions reported they were aware of the potential problems that the insider trading provisions could present, but said they had systems to prevent the provisions being a practical hindrance. Thus, one institution said it kept portfolio management completely separate from corporate governance: “Most corporate governance is done without reference to the portfolio manager.”

The institutions also said that, when they met with directors or managers of a company, it was assumed those directors and managers understood the law and would not tell the institutions something they should not. One institution said it was the company’s obligation to ensure it revealed only reasonable, public information, adding: “We would not expect to

³⁶ Corporations Law, Part 7.11, Div 2A.

be told anything that wasn't." Similarly, another said: "Companies should know where the boundaries are." One institution reported that there had been occasions when a company was about to reveal insider information and the institution had told the company to cease: "We value our ability to act independently more highly than whatever they are likely to say."

(3) Possibility of becoming a "shadow director"

Section 60(1)(b) of the Corporations Law defines the term "director" as including "person in accordance with whose directions or instructions the directors of the board are accustomed to act". This is commonly called the "shadow director" provision. In certain circumstances, institutional investors who become active in the affairs of the companies in which they invest could be shadow directors and hence subject to the directors' duties and insolvent trading provisions of the Corporations Law.

Institutions were asked if this impacted on how they monitored and intervened in the corporate governance of investee companies. None of the institutions reported that the definition of a director found in section 60 had affected the conduct of their business or their relationship with investee companies. One institution said: "If you hold two to three per cent of a company, the company will listen, but it's not persuasive." Another said: "We don't have a problem with [section 60] as we have a cultural antipathy to managing companies. Passive indexed investors are more tempted to take a management line."

(4) Former section 1069(1)(k)

Before 1 July 1998, when the Managed Investments Act overhauled the prescribed interest provisions in the Corporations Law, section 1069(1)(k) of the Corporations Law restricted the voting power of unit trust managers. It required that a unit trust deed contain covenants binding the trustee and manager not to vote the trust's shareholdings on any election of directors without the prior consent of the majority of unitholders. The ASC (1993) had granted limited relief to reduce the restrictiveness of the rule. Institutions were asked what difficulties the provision presented, and whether they supported repealing it. This is still a practical issue because there is a two-year transitional period for unit trusts to register under the Managed Investments Act regime. Until they come under the new regime, unit trusts will remain subject to the old law.

All institutions supported the repeal of section 1069(1)(k). The practical requirement of calling a meeting of unitholders was seen to be logistically difficult. The institutions said that unitholders were not even generally aware in which companies their funds were invested and were not usually interested; and that the investment manager, having been delegated the authority to vote in most instances by non-unit trust clients, should also have the authority to vote in respect of equities held through unit trusts.

One institution said: "It's logistically too difficult to put issues to unitholders. [Section 1069(1)(k)] is designed to make sure those shareholdings are never voted." Another said:

“It’s a complicated process of informing custodians about what they can do on which portfolios. [Section 1069(1)(k)] is there because of a fear of institutions acting on their own behalf,³⁷ but we are actually aware of our fiduciary obligation.”

Another institution said: “The manager is delegated authority to manage the business; voting is part of that management of assets. It’s a nuisance to have to circulate to unitholders who probably don’t care anyway. As a default, the manager should have the right to vote on any issue.” Another said: “If we want to vote, we want to vote all our shareholdings. If we can’t vote our unit trust holdings without calling a meeting, then that’s a restriction we prefer not to have. The unitholders don’t even know they have investments in a company.” Another commented: “[Section 1069(1)(k)] creates problems. Because we’re actually dealing through custodians, we have to rely on them to ensure we don’t breach [section 1069(1)(k)] by voting the whole lot. Also, it seems inequitable as we are voting our discrete clients across the board without any problems.”

(5) Minimum notice period for general meetings

What the guidelines say ...	
AIMA / IFSA	<ul style="list-style-type: none"> the annual report, notice of meeting and other documents for all shareholder meetings should be sent to shareholders at least 28 days before the meeting
Bosch	<ul style="list-style-type: none"> no recommendations
London Combined Code	<ul style="list-style-type: none"> no recommendations

At the time of conducting the interviews for this study, the Corporations Law set the minimum notice period for general meetings at 14 days. As a result of amendments made by the Company Law Review Act, which became operational on 1 July 1998, the minimum notice period is now 28 days for listed companies, and 21 days for other companies. AIMA (and subsequently IFSA) lobbied vigorously for the change to a 28-day minimum notice period.³⁸ In the interviews, institutions were asked whether 14 days was sufficient time for them to respond to the calling of a meeting and resolve how they were going to vote, or whether the minimum notice period should be extended.

Eight of the 12 institutions interviewed supported extending the minimum notice period. This is another illustration of an AIMA/IFSA view that has majority – but by no means universal – support of member institutions.

³⁷ This is an accurate assessment: When the provision was first introduced into Australian company legislation, the Minister for Justice said that “the restrictions imposed by the Bill arise out of the necessity to impose some curb on the enormous power capable of being exercised, not by the interest holders themselves but by the managers of the [unit trust] who actually may have little financial interest in a particular trust”: Harding (1994).

³⁸ See Parliamentary Joint Committee on Corporations and Securities (1996) paras 2.44-2.50; (1998) paras 1.45-1.47.

Of the eight institutions which supported extending the minimum notice period, four supported an extension to 21 days, three advocated 28 days, and one called for 30 days. One institution noted that, though the minimum notice period was 14 days, the effective period could be as short as seven days given the vagaries of the postal system and the time it took for the notice to get from the company to the custodian, and then to the institution's investment manager or analyst responsible for making the proxy voting decision.

Another institution described the difficulties with the process as follows: "We're dealing with custodians who themselves need five to seven days. The notices go to the custodians, then they send them out to us and then we have to give [the custodians] five days. That doesn't give us a lot of time to sit down and cogitate about the issue." Another institution said: "It's totally out of touch with the administrative realities of proxy voting. It's not enough time to consult clients if required. We advocate 28 days, particularly to enfranchise overseas investors". Another commented: "28 days would be a lot better for us. You've got various parties internally who need to review things, so the logistics of sending the proxy assessment around can be pretty cumbersome."

Of the four institutions that said the 14 days notice period was sufficient, one admitted that the deadline could be "a little tight if the issue is controversial and it's not an easy decision". Another institution which did not typically consult external clients found 14 days to be sufficient, but said that, with "the odd client who likes to be consulted, it gets a bit tight sometimes". Therefore, only two institutions said they had never encountered problems with the 14 day notice period.

(6) Proxy lodgment period

Section 250B of the Corporations Law requires proxies to be lodged at least 48 hours prior to the general meeting.³⁹ Institutions were asked whether they had experienced difficulty meeting this deadline.

Seven institutions said they were satisfied with the current requirement. One of those said that "48 hours is only not sufficient if the back office is slack". Another institution saw it from the investee company's perspective: "48 hours was always drafted in consideration of post. But if you look at Telstra, it'd take 48 hours to process all the proxies if all the little shareholders vote." Another institution supported shortening the time down to 24 hours, but qualified this by saying "it depends on the efficiency of the other side".

Of the five institutions which wanted the proxy lodgment period shortened, three advocated an electronic system which would allow lodgment closer to the time of the meeting. One institution said: "We strongly believe in electronic lodgment and that all voting at annual general meetings be by proxy. It's a real pain to lodge votes." Another

³⁹ The company's constitution or the notice of meeting may reduce the period: section 250B(5). However, it is common for the constitution to set the period as 48 hours.

said: "These days I don't see why 48 hours is necessary. I would have thought one hour would be sufficient. 48 hours is a relic of the non-electronic age."

B. Economic barriers

(1) The option of doing the Wall Street walk

Some commentators have argued that there is a fundamental difference between the type of shareholders who have ultimate control of listed German and Japanese companies, and the type of shareholders who ultimately control the majority of listed US, UK and Australian companies. The ultimate controllers of German and Japanese companies are "committed" shareholders: the evidence shows that they do not sell out in a crisis, but rather they stay put during (and sometimes become actively involved in) a rescue or restructuring of the stricken company (Edwards and Fischer 1994; Sheard 1989). However, institutional shareholders in US, UK and Australian listed companies have the option of doing the Wall Street walk: selling their shares. Indeed, one UK fund manager said in 1992 that there was "at least a 10:1 ratio" of sale over intervention at his institution (Black and Coffee 1994, p 2053).

None of the institutions reported that selling was a *first* instinct. Indeed, the converse appeared: all institutions reported that selling would generally be an option of last resort. Thus, one institution said: "We may sell after the battle's won or lost but not before the battle has begun. We'd rather stand up and fight than sell." Another institution reported it was constrained from selling by the requirements of indexing: "Tracking errors constrain how much one can deviate from the index, thus even active managers are required to hold big stock, eg, BHP and NAB, so one has to concentrate more on influencing a company rather than threatening to sell."

Three institutions said their investment style included buying into companies experiencing difficulty with a view to resolving that difficulty to improve the company and its share price. One of these institutions said: "If a fund manager perceives there is extreme value in a company which had not been unlocked because of some corporate governance issues, I think the attitude hardens far more towards activism or intervention than if it's a marginal case."

Similarly, another institution said: "It depends on your style as manager. If you've gone in as a growth investor and you think a company will grow faster than others and something happens to prevent that, you [sell and] go seeking the next growth stock. If you are a value investor, you buy cheap because there is a problem, and you have to deal with that problem to realise the value. If you're a passive investor, you're going to be in it anyway and it's got to be in your interest for the value of that stock to go up."⁴⁰

Another institution said: "You buy a company because you like what the company is doing and you think it can do well. If there's an opportunity to influence them, you ought to

⁴⁰ In regard to the final comment, see Section V.

do that rather than just dump the stock. Decisions to buy or sell are economically based, not morally.”

Another institution said its attitude depended on the size of its holding and its consequent ability to influence the investee company: “There’s a greater consciousness of good corporate citizenship these days and consequently the kneejerk reaction to sell is perhaps less prevalent. On the small cap side where you have the ability to actually be heard as a substantial shareholder, you have a better chance of actually making what you think is appropriate happen. With the larger stock, if you’re not in a position to influence it, you may well sell the stock.”

(2) Collective action and free-rider problems

Collective action and free-rider problems arise in the present context as a result of two key factors. First, any positive share price effects from monitoring or intervening will be enjoyed by *all* shareholders regardless of whether or not they participate in (or contribute to) the monitoring. Second, it is normal for the performance of fund management firms to be measured relatively rather than absolutely. That is, fund managers are assessed in comparison to the performance of their competitors or possibly an index. Taken in combination, this means that if one or two institutions spend resources intervening and (hopefully) increasing the value of a company’s shares, their competitors who also hold shares in that company can free-ride on their efforts – their performance will improve along with that of the intervening institutions but they will have spent nothing in the process. For this reason, a rational fund manager will only spend time and resources on detailed monitoring or intervening at an investee company in limited circumstances.

The key pre-condition to intervening is the possession of an overweight holding in the stock.⁴¹ Even though monitoring conducted by an overweighted fund manager would also benefit the performance of index-weighted and underweighted competitors, it would benefit the performance of the overweighted fund manager to a greater degree. Interviews conducted by Black and Coffee (1994) and Stapledon (1996a) have confirmed that UK-based fund managers do not participate in interventions when they have underweight holdings.

In the present study, institutions were asked whether they were conscious that their effective monitoring of investee companies became a collective good and that other shareholders, particularly other institutions, would take a free ride on their monitoring. Institutions were asked whether this acted as a disincentive against effective monitoring.

⁴¹ A fund manager’s index or market weighting in listed Australian equities is calculated as the market value of its total listed Australian equities under management divided by the market value of all listed Australian equities. A holding larger than index weight is an overweight holding, and a holding smaller than index weight is an underweight holding. A comparison of Tables 6.2 and 8.2 in Stapledon (1996a) reveals a considerable number of overweight institutional shareholdings in ASX All Ordinaries Index companies as at 1993.

All but one of the institutions reported they were conscious of the collective good/free rider problem, but only one reported that it acted as a disincentive: "It's a bit of a disincentive. For example, the press was asking what we intended to do about the BHP board. Our attitude was that we're not going to carry the ball. We only hold 2 per cent, so why does it always have to fall on us?"

The general attitude was that free riding occurred and there was nothing that could be done to prevent it: "Everybody tries to free ride on everybody else. That's what the market is about. It's just a factor in the investment equation." Another said: "[Free riding] is a problem; it's a fiercely competitively environment. But if it is actually going to result in better corporate structures and understanding of the issues, then maybe it's not such a bad thing." The competitive nature of the business was highlighted by another institution: "We work on the basis that we are not right 100 per cent of the time, and if someone wants to free ride, it's a risky business."

Two institutions saw free riding as a positive thing: "If you want to get your view across, the more the better. If you're going to do research anyway, there's no problem with it being widely disseminated."

(3) High cost of monitoring

Institutions were asked whether the high cost of effective monitoring of corporate governance issues of investee companies, in terms of money and resources, acted as a disincentive against their conducting that monitoring.

One institution specifically regarded the high cost as a disincentive: "We haven't quantified it, but it's got to be a disincentive. Even going to meetings would be a huge cost in terms of time away from the office for what is very little benefit in a lot of cases." Another institution doubted the benefit of monitoring: "It's not so much the cost but the cost versus benefit trade off. There doesn't appear, as yet, to be any special benefit in monitoring the way that certainly happens in the USA."

Generally, the other institutions admitted effective monitoring did come at a high cost, but considered it was a cost that could not be avoided. One institution said: "It's a cost we have decided to bear. Increasingly trustees of superannuation funds will count having a coherent corporate governance policy as a factor in hiring a fund manager." Another said: "Corporate structure and governance issues determine the future prosperity of investee companies, so they must be looked at."

(4) Potential conflicts of interest

Large institutional investors are likely to provide or offer to provide financial services to the companies in which they invest. For example, an institution which holds shares in an investee company might also manage the superannuation fund of that company, or another division of the same institution might provide insurance, banking or investment banking

services to the investee company. Institutions were asked whether this impacted on any decision whether or not to intervene in the corporate governance of an investee company. That is, did a fear that the investee company may terminate the institution's services (as insurer, banker, etc) – on the basis that it was a meddling investor – act as a disincentive against the institution intervening? US studies indicate that this is a real issue. These studies of voting behaviour on anti-takeover proposals (generally found to be wealth-decreasing for shareholders) have found evidence of a bias towards pro-management voting by institutional investors having actual or potential business ties with the companies concerned.⁴²

Three institutions said they did not supply other financial services to their investee companies, so the problem was not an issue for them, though two of them acknowledged its potential. One said: "We are not permitted to have external private-sector clients, but the problem may arise in the future."

One institution expressly conceded that the potential for a conflict of interest presently acted as a disincentive: "It's the obvious advantage of confidential voting. We need to create internal Chinese walls but that is not a particularly effective way of doing business. Good business is built on trust, and if you are having to do that stuff it detracts from the trust."

Several other institutions acknowledged some difficulties. One said that, where it was voting against a resolution and it had a client relationship with that investee company, "we would still do it but we would let them know". Another said: "We would hesitate before acting. We would try to keep the two separate. Realistically there would be occasions where there might be conflict."

One institution which was active in re-insurance said the potential conflict did impact directly on its relationship with client investee companies: "If one of our clients is a public listed company, and we also own shares in that client, then obviously there's a potential problem that, if we are critical on the share side, it might impact on the re-insurance side. We have to take a fairly commonsense approach and realise you are operating in one business and you have to temper your holdings or views because of the other side of the business."

Two institutions also mentioned the problem that might arise when an institution held shares in its parent company: "We are also shareholders in our parent, but the fiduciary duty overrides this and so we will implement normal policy." The other said: "We used to have a mandate that said you can invest in any shares except your own. We did not like that because sometimes we genuinely wanted to hold it."

Three institutions claimed that the fact they supplied other financial services to an investee company would not affect how they exercised the votes on behalf of their clients, with the fiduciary duty to the client being the overriding factor for one institution: "We are

⁴² See Brickley, Lease and Smith (1988, 1994); Payne, Millar and Glezen (1995).

very concerned about what our duty is.” Another said: “It shouldn’t affect your judgment. We’re quite happy to sell their shareholdings out and they’re quite happy to change their [fund] managers from time to time.”

C. Practical barriers

(1) Lack of information

Where an institution intervenes at an investee company, the senior management and board of the company will have access to more material information than the institution. Institutions were asked whether the fact that they might not have all information impacted on their decision to intervene or not on a corporate governance issue.

None of the institutions said this factor influenced a decision to intervene or not. Indeed, three institutions said they would expect the board to have more information than they did: “You hope the board knows more about the company than you do; you’d be disappointed if they did not.”

Three institutions said it might impact future relations with the board. One said: “If we felt information was being withheld, we would seek to have new directors installed next time.” Similarly, another institution said: “If the board is doing something, we expect to be told the reasons behind it. Whether they are giving full information comes back to judging management by how well it does what it says it will do. They might try to pull a swiftie but they won’t do it twice.”

Generally the institutions said they would not even be aware of whether the board was withholding information from them or not: “Half the time we don’t know. We can only decide on what information we have, and if that decision is not perfect because the information is not, that’s [the company] management’s fault and they deserve to be treated harshly.”

(2) Difficulty of getting institutions to meet at short notice

Two institutions considered the logistical difficulty of getting institutions to meet at short notice, to discuss a problem concerning a company in which they held shares, did present a problem: “Everybody is busy, it’s hard to get together. But if something is urgent enough, you make it happen.” Generally the nine other institutions thought a meeting could be organised at short notice.

(3) Requirement to consult client

The institutions were asked whether any requirement to consult a client on an issue had inhibited their ability to act quickly when swift action was necessary.

Three institutions reported that a requirement to consult clients had inhibited taking swift action. One institution said this had had an impact, “particularly with public-sector

clients where we can't exercise the vote without consent from their board. Generally their votes go dormant." Another institution had one client which it was required to consult: "It's a slow process because the client has to get a quorum together to discuss the issue and that slows down the whole process."

Five institutions said it was within their discretion whether clients were consulted beforehand in any case. One institution queried what issue required such swift action in the first case, pointing out that the Coles Myer issue evolved over the course of months.

VII. Analysis and conclusions

The findings of this interview study reveal a number of characteristics of institutional investors, and features of their involvement in corporate governance. They include:

- Institutions are not monolithic. Although they share similar views on some matters of general principle, different institutions commonly take different approaches to corporate governance issues. This reflects the fact that they are fierce competitors in the investment management industry.
- It is therefore not surprising that the level of enthusiasm for any particular best practice guideline in the AIMA Blue Book varies from one institution to the next. While the guidelines certainly appear to enjoy majority support, the lack of universal backing may partly explain why some corporate governance practices in listed Australian companies do not conform with the guidelines.
- Quite a few institutions still do not exercise their voting rights routinely – preferring to vote only on contentious issues or issues of major significance.
- Most institutions would not support any proposal to make voting mandatory for institutional investors. However, institutions are roughly evenly divided as to whether voting should be done on a confidential basis – to alleviate conflicts of interest.
- Most institutions maintain routine contact with the companies in which they hold shares. This contact is mostly at the CEO and senior management level, and only rarely involves non-executive directors. Some institutions believe that a dialogue with independent non-executive directors would be a useful addition to the corporate governance process.
- When institutions are dissatisfied with the performance or corporate governance of an investee company, they have three main options: sell the shares, intervene or do nothing. Reasons for intervening rather than selling commonly revolve around the share price. Either the institution's shareholding is so large that it would be difficult to sell out all at once at a reasonable price; or the company's shares are trading below the net tangible asset value; or the institution thinks that intervention will lead to an increase in the share price.
- The legal barriers to institutional investor activism considered most significant by institutions themselves – the minimum notice period for general meetings and the restriction on voting by unit-trust managers – have decreased significantly since the 1 July 1998 reforms to the Corporations Law made by the Company Law Review Act and the Managed Investments Act.
- There are some economic and practical barriers to institutional investor activism – such as the cost of intervening, collective action and free-rider problems, potential conflicts of interest and lack of information. Several of the institutions that were interviewed downplayed the significance of these economic and practical barriers. However, the responses of the interviewees on these issues should be treated with a degree of caution,

because this is an area where the best evidence is observed patterns of behaviour rather than the views of the players. What do we find if we focus on actual behaviour? Two things stand out. First, a significant proportion of institutions still have a policy of not exercising voting rights on “routine” motions. Second, large-scale costly interventions have occurred infrequently in Australia – even taking into account the fact that this sometimes occurs entirely behind the scenes.

In conclusion, the increasing level of institutional share ownership in Australia is likely to see institutional investors continuing to play a significant role in corporate governance. However, there are limits to what can be expected from institutions. The economic and practical barriers just mentioned must be taken into account. Also, it must be borne in mind that there are several other forces at work in the area of corporate governance – including the market for corporate control (hostile takeovers, and the threat of hostile takeover), monitoring by independent non-executive directors and performance-based remuneration schemes for senior executives. That is, institutional investor activism is but one of several mechanisms which operate to align the interests of management and shareholders.

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**The New Financial Architecture and
Effective Corporate Governance**

Professor John H. Farrar

GLOBALISATION AND EFFECTIVE CORPORATE GOVERNANCE

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THE NEW FINANCIAL ARCHITECTURE AND EFFECTIVE CORPORATE GOVERNANCE

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The objects of this paper will be to discuss the meaning of “the new financial architecture” and “corporate governance”, the nature and impact of globalisation, particularly on regionalism and reform of national corporate laws. It will review previous attempts to deal specifically with the regulation of multinational and transnational corporations and examine the experience of the European Union in integration of laws on corporate governance. Lastly, it will consider the place of a broader concept of corporate governance in the new financial architecture including the emerging norms of global corporate governance which are of an essentially self regulatory nature.

THE NEED FOR A NEW GLOBAL FINANCIAL ARCHITECTURE AND EFFECTIVE CORPORATE GOVERNANCE

The use of the word “architecture” in this context is metaphorical or extended. Architecture literally means a style of building.¹ Here it is being used in an extended sense as it is in relation to computer systems where it refers to the conceptual structure and logical organisation of a computer or computer-based system.² Here it refers to the

¹ *Shorter Oxford Dictionary.*

² *Ibid.* See Markus Ebert, “The Asian Financial Crisis and the Need for a New Global Financial Architecture” (1998) *Butterworths Journal of International Banking and Financial Law* 454; Barry Eichengreen, *Towards a New International Financial Architecture*, Institute for International Economics 1999; Robert Rubin, Speech April 21, 1999 on Reform of the International Financial Architecture to the School of Advanced International Studies. <http://www.treas.gov/press/releases/pr3093.htm>.

structure of the evolving global financial services markets or a desirable regulatory structure to encompass them.

We examine below the many and varied factors which are currently swept up in the term globalism or globalisation. The principal driving forces have been capital market imbalances, innovations in computer and telecommunication technology, deregulation and the influence of modern finance theory on risk and diversification, hedging and arbitrage.³ These forces prompt national securities regulators to seek a set of international cooperative measures to facilitate effective regulation of domestic markets.⁴ Also they highlight the maze of contradictory regulatory requirements which have evolved for path dependent reasons in different jurisdictions.⁵ On the other hand diversity in regulation can sometimes serve useful economic ends in the sense of promoting innovation and competition without necessarily leading to a race to the bottom.⁶

The protracted South East Asian financial crisis and the agreement on financial services through the ratification of the General Agreement on Trade and Services (GATS) have occasioned a call for a *new* financial architecture to improve the level of transparency, accountability and prudential supervision and regulation of the financial services industry.⁷ Thus George Soros in his new book *The Crisis of Global Capitalism*⁸ has argued that the present system is inherently unstable and he argues against the view that financial markets tend towards equilibrium. His argument is influenced by Karl Popper's philosophy and is based on fallibility, reflexivity and open society.⁹ Others, while not espousing such theoretical assumptions, argue a similar case.¹⁰

³ Joseph A Grundfest, "Internationalisation of the World's Securities Markets: Economic Causes and Regulatory Consequences" (1990) 4 *Journal of Financial Services Research* 349, 360-365.

⁴ *Ibid* 367-370.

⁵ *Ibid* 367, 370-1.

⁶ *Ibid* 367, 371-373.

⁷ Ebert *op. cit.*

⁸ Little Brown & Co, London 1998.

⁹ *Ibid.* Preface and Chapter 1.

¹⁰ See eg. Richard O'Brien, *Global Financial Integration: The End of Geography*, The Royal Institute of International Affairs, 1992, 101 et seq.

The arguments are for:

- (1) a common set of objectives
- (2) the selection of an appropriate supervisory body with
 - (a) universal appeal
 - (b) the necessary supervisory skills
 - (c) enforcement powers.¹¹

It has been argued that of the main international bodies the WTO seems best suited to this role in relation to financial services although it has limited dispute resolution powers and a currently frozen budget. The GATS has the support of 102 nations which are committed to integrating their economies to create a new global economic system.¹²

In developing a new system characterized by transparency, accountability and effective regulation of the financial services industry the promotion of similar virtues in the portfolio companies is arguably a necessary corollary.

However, to understand these trends one needs to see how the present situation has come about. To do this we have to look first at the forces of globalisation which have led to it and how nation states, regions and international bodies have attempted to deal with some of these forces in the past. In doing so we can place corporate governance more accurately in an international perspective and see what, if any, lessons, can be learned from the past. However, before we do this we must consider the meaning of corporate governance.

The term 'corporate governance' which emanates from the United States of America has become a fashionable idea in the last decade. Like most fashionable ideas it is remarkably imprecise. In fact, a number of ideas are in circulation under this heading and a number of interests are staking their claims to recognition in the administration of corporate affairs. Although many ideas about corporate governance have an international

¹¹ Ebert op. cit 460-2.

¹² Ibid 462.

quality, each country has approached it against a background of its own distinctive culture. In Australia for example, one sometimes has the impression that this lies somewhat uneasily between the culture of the outlaw Ned Kelly and that of his gaoler.¹³

If we adopt the position that corporate governance is about the legitimacy of corporate power, corporate accountability and the standards by which the corporation is to be governed and by whom, it is obvious that the concept transcends legal standards and liability, perhaps reflecting the fact that the law deals with a minimal morality of obligation rather than a morality of aspiration.¹⁴

Corporate governance debate is often about the method as opposed to the substance of corporate decision making. Nevertheless it seems too narrow to limit it exclusively to questions of method and good housekeeping.

A residual question is whether the evolving structure of the financial services markets or the norms of global corporate governance represents a form of global law without a state – a self validating Global Bukowina as Gunter Teubner has referred to it,¹⁵ echoing the sociologist of law, Eugen Ehrlich who came from the Bukowina region of the former Austro Hungarian Empire now incorporated in the Ukraine. Ehrlich, it must be remembered, wrote that “The centre of gravity of legal development ... from time immemorial has not lain in the activity of the state, but in society itself, and must be sought there at the present time.”¹⁶ The idea of a “living law” which transcends nation states and conventional legal sources and forms has some kind of appeal in this as in other areas of commercial life.

¹³ See J H Farrar, “Corporate Governance, Business Judgement and the Professionalism of Directors” (1993) 6 Corporate and Business Law Journal 1.

¹⁴ Ibid.

¹⁵ G Teubner, “‘Global Bukowina’: Legal Pluralism and the World Society” Chapter 1 in G Teubner (ed). *Global Law Without a State*, Dartmouth, Aldershot 1997.

¹⁶ Eugen Ehrlich, *Principles of the Sociology of Law* Harvard University Press, Cambridge, 1936, 390.

GLOBALISATION AND TRANSITION

We live in a complex period of transition and the consequences of dismantling a world order built up in the aftermath of the Second World War. This is characterised by the following diverse phenomena:-¹⁷

- (1) The breakdown of the World International Monetary Order agreed at Bretton Woods in 1944;
- (2) The growth of multinational and transnational corporations and enterprise since 1945;
- (3) The rapid development of computer and telecommunications and the resulting reduction in trading costs on international capital markets;
- (4) The International Financial Revolution;
- (5) The rise of international institutional investment;
- (6) Capital market imbalances caused by differences in savings rates and investment opportunities and international trade imbalances such as the OPEC and later Japanese surpluses;
- (7) The collapse of Communism in the former USSR and Eastern Europe;
- (8) The decline of statism and the growth of corporatisation and privatisation of public enterprise;
- (9) The growth of regionalism with such bodies as the European Union and NAFTA and the attempts to activate an Asian Pacific region through APEC which is complicated inter alia by the presence of the USA and Canada as cockoos in the nest;

¹⁷ See inter alia Grundfest op. cit; O'Brien op.cit; *Financial Times Mastering Global Business* FT Pitman Publishing, London, 1999; Paul Hirst and Graham Thompson, *Globalisation in Question*, Policy Press, Cambridge 1996; Kenichi Ohmae, *The End of the Nation-State: The Rise of Regional Economics*, Harper Collins London 1995; D Held, D Goldblatt, A McGrew and J Perraton, "The Globalization of Economic Activity" (1997) 2 *New Political Economy* 257; William Greider, *One World, Ready or Not* Penguin Books, London 1998; Robert Reich, *The Borderless World: Power and Strategy in the Interlinked Economy*, Collins London 1990; *The Work of Nations*, Vintage Books NY 1992; John Wiseman, *Global Nation – Australia and the Politics of Globalisation*, Cambridge University Press, Cambridge 1998; Hans-Peter Martin and Harald Schumann, *The Global Trap: Globalization and The Assault on Prosperity and Democracy*, Pluto Press, Sydney, Australia, 1997;

- (10) Falling trade barriers and increasing international competition;
- (11) The rise of some developing countries such as China and India which have vast economic potential.

Much of this we attempt to sum up in the protean term 'Globalisation'. The idea of globalisation is not new. Exploration, trade and migration have always been with us. Likewise the transmission of information over long distances through trade routes and the like. Some of the events which we have described are interlinked but sometimes the question of causation is complex. Globalisation is currently the subject of many books and articles. One of these has the suitably ambiguous title 'Globalisation in Question'. In a useful short chapter in the Financial Times publication *Mastering Global Business*,¹⁸ Professors Vijay Govindarajan and Anil Gupta define globalisation as "the growing economic interdependence among countries as reflected in increasing cross-boarder flows of goods, services, capital and know-how." They cite the following trends as evidence:-

- Between 1989 and 1996 cross border trade in goods and services grow at an annual average rate of 6.2%.
- From 1980 to 1994 foreign direct investment grew from 4.8% to 9.6% of World GDP.
- In 1970 cross border transactions in bonds and equities as a ratio of GDP stood at under 5% in the US, Germany and Japan. By 1996 the respective figures were 152%, 197% and 83%.¹⁹

Globalisation can be looked at at the level of a specific country or a specific industry or a specific company.²⁰

Thus China for example globalised its economy much faster than India in the period 1980 to 1994.²¹

Towards a More Coherent Global Economic Order, Forward Studies Series, European Communities 1998. See generally the *Global Legal Studies Journal* since 1993.

¹⁸ Op cit p5.

¹⁹ Ibid.

In the case of the pharmaceutical industry worldwide production increased 7.4%, cross border trade 10.9% and cross border investment 14.9% per annum in the period of 1980 to 1994.²²

Toyota is an example of a globalised company with one third of its global output from affiliates in 25 different countries.²³

What is new about the current processes is the extent to which time and space have been compressed by new technologies and the impact this has had on the patterns of financing corporations and spreading risk in investment.²⁴

IMPACTS OF GLOBALISATION

In a complex relationship of cause and effect of globalisation an increasing number of countries are adopting the techniques, if not the ideology of the free market. The advances in technology are constantly improving communications. This interacts with market forces in a similarly complex way. The removal of barriers to trade and investment creates opportunities for national companies in overseas markets but it also opens the door to competitors in domestic markets.²⁵ The impact of this is affecting labour markets in developed countries. The speed and complexity of change has threatened the capacity of national governments to deal with the local impact of change, particularly when this results from events taken on the other side of the world.²⁶

In the past national governments have mainly encountered globalisation through the activities of multinational and transnational enterprises.

²⁰ Ibid 5-7.

²¹ Ibid 6.

²² Ibid 6.

²³ Ibid 7.

²⁴ Grundfest op cit; O'Brien op cit.

²⁵ *Mastering Global Business* op cit 9.

²⁶ Ibid.

Transnational enterprise has constantly eluded the regulation of nation states and even regions in the period since the Second World War. It would be a mistake to think that all such enterprise is necessarily a large widely held publicly listed corporation. However many of the significant players are and it is to the various attempts to regulate them that we must now turn to see what lessons can be learned.

PAST EXPERIENCE IN DEALING WITH GLOBALISATION – REGULATING MULTINATIONAL AND TRANSNATIONAL ENTERPRISE²⁷

The multinational enterprise represents the latest stage of development of the national company group which evolved from a local corporate enterprise which in its turn evolved from a local non-corporate enterprise. Just as the issues of ownership and control are important in relation to national enterprises they are crucial in relation to multinational enterprise where the resolution of the question necessarily has a political significance. The multinational enterprise poses additional problems because it is not simply one discrete legal form but many. As the late Wolfgang Friedman wrote: “It is the complexity of its legal structure, or rather the interplay of legal entities and relationships constituting that structure, no less than the size of its resources or the scale of its operations, which makes its power so elusive and so formidable a challenge to the political order and rule of law. It is therefore inherent in the nature of the multinational corporation that there is no simple solution for the problem of its relationship to states, the world of states, or an organised world community....²⁸

The political and legal regulation of multinational enterprise can be classified under 4 headings which approximately correspond to stages of historical development. These are:

²⁷ This is based on JH Farrar and B Hannigan, *Farrar's Company Law*, 4th ed. Butterworths, London, 1998, Chapter 44.

²⁸ *Transnational Law in a Changing Society*, 1972, 79, 80. See also C M Schmitthoff [1972] JBL 103.

- (1) national;
- (2) bilateral;
- (3) regional; and
- (4) international regulation.

Let us deal with each in turn.

National regulation

It is necessary to distinguish between prescriptive and enforcement jurisdiction. The jurisdiction to make prescriptive laws is very wide, and may be based on territory, nationality or probably even the fact that particular conduct has effects in the state purporting to exercise jurisdiction.²⁹ By contrast, the jurisdiction to enforce those laws is narrow, limited to the territory of the state in question. Hence, there are problems with national regulation where the multinational keeps the bulk of its assets outside the state seeking to regulate it: the latter will be unable to access those assets to satisfy judgments. As an additional problem, states may have prescriptive jurisdiction under the effects doctrine (eg, where a multinational competitor engages in export dumping, thereby threatening a state-owned industry), but will not be able to enforce it unless the multinational is present within the state. That is, a state may suffer at the hands of multinational, but may not have any national means of redress open to it.³⁰

A liberal regime to domestic companies by the countries of origin created the economic conditions which favoured the growth of multinational enterprise. The United Kingdom (“UK”) for instance has generally favoured a very liberal regime like other European states. To a large extent this has been based on enlightened self-interest since the UK is the headquarters of a number of multinationals and the City of London has traditionally financed many multinational operations.

²⁹ See I A Shearer, *Starke's International Law* (11th ed), ch 8.

For host states there is often a dilemma of regulating conduct against the national interest yet not discouraging foreign investment. Canada in the past has been faced with this dilemma because of its proximity to the USA. On the whole it has favoured the presence of subsidiaries of foreign corporations although since 1972 it has screened new direct foreign investment.³¹

The main worries apart from loss of control that the individual nation has is that multinationals may reduce the effectiveness of national monetary policy, evade taxation and injure labour relations.

The most effective and systematic form of regulation seems to be the control over initial capital investment. Control over later behaviour seems to be more ad hoc, particularly in those host countries without a strong legal tradition.

Bilateral regulation

In the last three decades there has been a growth in bilateral arrangements. These have taken the form of investment protection and promotion treaties and reflect the desire of home country governments to protect the investment of their companies abroad and the desire of host countries to attract foreign direct investment. Such treaties normally provide for legal protection of foreign direct investment. Such treaties normally provide for legal protection for foreign subsidiaries and aim to produce a stable environment for development. In the period between 1945 and the mid 1960s the USA was the first country to seek to achieve its objectives in this manner. Many of the bilateral treaties were concluded with developed countries. The emphasis of the early treaties, however, was more to do with international trade and protection of citizens abroad rather than foreign direct investment. From the 1960s onwards the treaties tended to be more

³⁰ P Bondzi-Simpson *Legal Relationships Between Transnational Corporations and Host States* (1990), 33-8.

³¹ RE Tindall *Multinational Enterprise: Legal and Management Structures and Inter Relationship with Ownership, Control, Antitrust, Labor, Taxation and Disclosure*, Oceana, Dobb Ferry, NY (1975); JE Spero and JA Hart, *The Politics of International Economic Relations* (5th ed Unwin, Sydney 1997), Chapter 4.

concerned with foreign direct investment and many of these were concluded with developing countries. In this period the Federal Republic of Germany concluded more than 50 agreements of this kind by the end of 1983. There are today more than 200 such treaties in force and many of these have been initiated between OECD countries and developing countries. It should be noted that such treaties do not normally contain obligations on home country governments to promote foreign direct investment. The mere existence of an investment protection treaty is unlikely to lead to increased flows of investment unless there are other inducements. Conversely the absence of such a treaty where there are such other inducements will not necessarily deter foreign investment. The role of such treaties, therefore, is simply marginal in the decision-making of the multinational and the host country.³²

Regional regulation

The USA, Canada and Australia are all federations, yet each effectively operates as one economic unit. Since 1954, there have been a number of looser economic groupings such as EFTA, EU and NAFTA. Other groupings such as OPEC have been established on the basis of specialised markets.

Of these groupings of states the most important for our purpose is the EU. Here, the lack of any provision in the Treaty of Rome has hindered progress. The member states have consistently refused to yield any national authority to the EU. In the past, various attempts – the adoption of a regulation of foreign investment in 1965, a Commission proposal to protect employees in the event of takeovers, the formulation of common industrial policy and the adoption of a convention on internal mergers – were all unsuccessful.³³ Recently, however, mergers and joint ventures affecting market structure significantly have to be approved by the Commission and multinationals operating the

³² See *Bilateral, regional and international managements on matters relating to transnational corporations. Report of the Secretariat of the UN Economic and Social Council E/C10/1984/8* 6 Feb 1984 on which this is substantially based.

³³ *Spero*, op cit 134-137. See *Multinational Undertakings and Community Regulations EEC Bull Supp 15/73*; *Industrial Policy in the Community 1970*; *Draft Convention on International Mergers EEC Bull Supp 13/73*; JH Dunning and P Robson (1987) 26 *JCMS* 103.

EU with 1000 or more employees in more than one EU country are required to set up European Works Councils. These affect multinational enterprise as do the accounting and auditing changes.

International regulation

The International Monetary Fund (IMF), the General Agreement on Tariffs and Trade (GATT) and the Organisation for Economic Co-operation and Development (OECD) all have some bearing on the activities of multinationals. The IMF provides for convertibility of currency and repatriation of funds. GATT facilitates international production and transfers. Of particular relevance are the two fundamental GATT obligations: most favoured national and national treatment. In addition there are multinationals' traditional concerns with trade related aspects of intellectual property rights and trade-related investment measures. There is also now the GATS agreement on trade in services which parallels GATT. The OECD facilitates freedom of establishment.

On the other hand, the special attempts to deal with multinational enterprise have not been successful. The Havana Charter which was to have provided for a liberal regime of foreign investment was later amended by Third World countries to protect host countries and was opposed by the USA.³⁴

In 1976, the OECD adopted voluntary guidelines for conduct by multinationals.³⁵ The guidelines are recommendations jointly addressed by the member countries to the multinationals operating within their territories. They are not legally binding. There is no precise definition given of 'multinational', although the guidelines refer to groups which 'comprise companies and other legal entities having private, public or mixed capital, established in various countries and linked in such a manner that one or more of them are in a position to exercise significant influence on the countries of others, and in

³⁴ Spero, *op cit*, 138.

³⁵ See *Review of the 1976 Declaration and Decisions on Guidelines for Multinational Enterprises* (OECD, 1979); H Schwamm (1978) 12 JWTL 342. See now *The OECD Guidelines for Multinational Enterprises* (1994).

particular to share knowledge and resources amongst themselves'. The guidelines contain a statement of general policies and then deal with six topics – disclosure of information; competition; financing; taxation; employment and labour relations; and service and technology.

With regard to disclosure, the number and scope of the items of information called for is extensive while at the same time an attempt is made to protect the legitimate requirements of business secrecy.

An acute problem which the guidelines address is the question of transfer pricing, and here it is provided that multinationals shall refrain from making use of transfer pricing which does not conform to an arms' length standard.

A third problem is the question of bribes. Here the guidelines draw the line at what is legal although even this is questionable since some payments which are legal may still be grossly immoral.

In the 1970s, the United Nations set up a Centre on Transnational Corporations (CTC) to gather and disseminate information on multinationals and an intergovernmental Commission on Transnational Corporations to act as a forum for discussion of issues relating to them and to supervise the centre.³⁶ Of these two bodies, the first will probably prove the most practical since ignorance of empirical data impedes rational debate and leads to perpetuation of myth.

From 1977 until 1992, a Working Group of the Commission was engaged in the formation of a code of conduct as its highest priority. It decided against taking the OECD guidelines as its starting point.³⁷

³⁶ See PD Maynard (1980) 2 Co Law 226; (1983) 4 Co Law 103. (1983) 9 Commonwealth Law Bulletin 259. See the materials collected in Simmonds (ed) *Multinational Corporations Law*.

The benefits of such a code were considered by the Round Table on the Code of Conduct of Transnational Corporations held in Montreux, Switzerland in October 1986. The Round Table saw the Benefits as being as follows:

- (a) It would establish a balanced set of standards of good corporate conduct to be observed by multinationals in their operations and of standards to be observed by governments in their treatment of multinationals.
- (b) It would help to ensure that the activities of multinationals were integrated in the development policies of the developing countries.
- (c) It would establish inter alia the confidence, predicability and stability required for development of foreign direct investment in a mutually beneficial manner.
- (d) It would contribute to a reduction of friction and conflict between multinationals and host countries.
- (e) It would “encourage positive adjustment through the growth of productive capacities.”

Progress on the code was slow and in 1992 it was announced that no consensus was possible. The CTC was absorbed into UNCTAD in Geneva.

Since 1992 the focus has shifted to environmental protection as a follow-up to the UN Conference on Environment and Development. There has been a recognition of four trends in relation to multinationals and transnationals:

- (1) the growing role of such entities in sustainable growth;
- (2) the expansion of corporate environmental management practices;
- (3) harmonisation of environmental regulations affecting them; and
- (4) the emergence of voluntary environmental guidelines by such entities.

³⁷ See *The United Nations Code of Conduct on Transnational Corporations* UNCTC Current Studies (1988). For some discussion see Maynard (1983) 4 Co Law 103 at 104; Sanders (1982) 30 Am J Comp L 241; P Hansen and V Aranda (1990-1) 14 Fordham Int LJ 881.

In addition there has been work done by a number of international institutions, including the Intergovernmental Group of Experts established by the Centre of Transnational Corporations, on the elaboration of international standards on accounting and reporting. Also there has been the establishment of the Multilateral Investment Guarantee Agency ('MIGA') under the aegis of the World Bank. MIGA's main role is to provide insurance coverage for non-commercial work involved in transnational investments.

Over twenty years ago the International Accounting Standards Committee ("IASC") and the International Federation of Accountants ("IFAC") were set up by the accounting profession to develop international standards for the preparation and verification of corporate information.

The role of IASC is to develop International Accounting Standards ("IASs") which are produced by a consultative process. A Standing Interpretations Committee examines urgent issues arising from interpretation of the existing standards or new matters of concern. The role of IFAC is wider. It includes the development of International Standards of Auditing ("ISAs") and a Code of Ethics. IFAC is not involved in the development of accounting standards but simply in assisting in their promulgation.

In December 1996 the meeting of Ministers of the World Trade Organisation encouraged the successful completion of international standards in the accounting sector by IFAC, IASC and the International Organisation of Securities Commission. ("IOSCO").³⁸

Support for these initiatives has come from the group of Seven, the World Bank and the United Nations.

It is of course easy to dismiss such voluntary codes as unimportant since they are not legally binding. This would, however, be a mistake. Such codes may form the basis of subtle diplomacy by the UN towards a consensus among governments which in turn will

³⁸ See Frank Harding, "Corporate Credibility – Why a Harmonised Global Accountancy Framework Matters" (1999) *Accountancy Ireland* 16 (April issue) on which the above relies.

be embodied in national legislation or professional standards. Such a consensus will in any event help host countries in negotiating with multinationals and may assist trade unions in both the home countries to oppose outward investment and the host countries to seek regulation of multinational practices against the interests of their members.³⁹

GLOBALISATION, REGIONALISM AND NATIONAL CORPORATE LAW MODELS – MARKETS OR HARMONISATION?

The impacts of globalisation motivate developed countries to think about regional trade blocs and harmonisation of laws. They also motivate developing countries to think of adopting new laws based on major western models.⁴⁰

In the last hundred and fifty years there has been a number of dominant western models of corporate laws and securities regulations. Historically the British imperial model was important until the 1960s. It was adopted in the countries of the Commonwealth and had some influence beyond those boundaries.⁴¹ Germany at the end of the Nineteenth Century and in this century has been a successful innovator in the use of the corporate form and contributed the private company, two tier boards, worker participation and a novel approach to groups.⁴² This has had influence in Western Europe, Japan and Korea.

³⁹ See M Crawford “The Case against Multinationals: The Main Criticism Re-examined” in the EIU Special Report No 79 *Ten Years of Multinational Business*, p 15. See also the very useful paper by TH Reynolds “Clouds of Codes: The New International Economic Order through Codes of Conduct: A Survey” in Simmonds (ed) *Multinational Corporations Law*, vol 4; *North-South: A Programme for Survival*, The Report of the Independent Commission on International development Issues under the chairmanship of Willy Brandt (1980), chapter 12.

⁴⁰ Take for instance the recent examples of the Peoples Republic of China and Indonesia.

⁴¹ See J H Farrar and BM Hannigan, *Farrar’s Company Law*, 4th ed, Butterworths London 1998, Chapter 42.

⁴² See H Wurdinger, *German Company Law*, Oyez Publishing, London, 1975; Jonathan Charkham, *Keeping Good Company: A Study of Corporate Governance in Five Countries*, Clarendon Press Oxford 1994 Chapter 2; Klaus Hopt, “The German Two-Tier Board (Aufsichtsrat): A German View on Corporate Governance,” in Hopt and Wymeersch (eds) *Comparative Corporate Governance*, Walter de Gruyter Berlin, 1997, Chapter 1.

Since 1933 the USA has been one of the world's leaders in corporate law and securities regulation although some would have the influence earlier.⁴³

The United States is a continent as well as a country and has opted for a market approach to corporate laws.⁴⁴ Each state is a separate corporate law jurisdiction with its own Business Corporations Act although much of securities regulation is federal. The extent of the market for corporation law statutes can be exaggerated due to the dominance of Delaware and the Revised Model Business Corporations Act which is adopted in a number of states.⁴⁵

Canada since the 1970s has been increasingly influenced by US corporate law ideas. The US influence was strong on the Ontario reforms of the 1970s and the subsequent Dickerson Report which led to the Canada Business Corporations Act. Canada has a greater degree of similarity between the Ontario, federal and a number of the other provincial statutes than the USA but still lacks uniformity.⁴⁶

Since 1962 Australia has developed uniform laws and an effectively national scheme. This in turn influenced Malaysia and Singapore in its 1962 form.⁴⁷

Since 1973 the United Kingdom has been a member of the European Union and been subject to an elaborate scheme of harmonisation of laws which has recently lost some of its momentum. In the comparative quietus the United Kingdom is attempting a thorough reform of its Company Law, a project which bears an ill defined relationship to its European Union obligations.⁴⁸

⁴³ Roberta Romano *The Genius of American Corporate Law*, AEI Press, Washington DC 1993, 13.

⁴⁴ Romano op cit.

⁴⁵ See Cally Jordan, *International Survey of Corporate Law in Asia, Europe, North America and the Commonwealth*, Centre for Corporate Law and Securities Regulation, Melbourne 1997, Part 4.

⁴⁶ Jordan op cit, F Iacobucci et al *Canadian Business Corporations*, Canada Law Book Ltd, Agincourt, 1977, Chapter 1.

⁴⁷ See Walter Woon, *Company Law* 2nd ed. FT Law and Tax Asia Pacific, Singapore 1997, 4.

⁴⁸ See *Modern Company Law for a Competitive Economy – The Strategic Framework*, Company Law Review Steering Group, DTI, London, 1999.

Important questions thus face each nation state as to which models of company law and securities regulation best serve in an era of globalisation. Let us see what can be learned from the experience of the European Union since this is the most elaborate attempt to produce harmonised laws on an international basis.

THE PROCESS OF HARMONISATION OF NATIONAL CORPORATE GOVERNANCE LAWS IN THE EU⁴⁹

Relevant provisions of the Treaty of Rome⁵⁰

Article 2 of the Treaty sets out the goals of the EU. These include establishment of a common market and an economic and monetary union and progressive approximation of the economic policies of member states, to promote throughout the community a harmonious and balanced development of economic activities, and closer relations between the states belonging to it. Article 3 provides that for the purposes set out in art 2, the activities of the EU shall include, inter alia, (c) an internal market characterised by the abolition, as between member states of obstacles to freedom of movement of goods, persons, services and capital, and (h) the approximation of the laws of member states to the extent required for the proper functioning of the common market.

The Treaty recognises certain basic freedoms. These include the right of establishment. Article 52 provides for the abolition of restrictions on the freedom of establishment of nationals of a member state in the territory of another. This includes freedom to set up and manage undertakings, in particular companies or firms within the meaning of art 58. Article 58 gives a broad definition of companies or firms. It means companies or firms constituted under civil or commercial law, including cooperative societies, and other legal persons governed by the public or private law, save for those which are non-profit-

⁴⁹ This is partly based on *Farrar's Company Law* op cit Chapter 3. See generally William Davey, "European Integration: Reflections on its Limits and Effects" (1993) 1 *Global Legal Studies Journal* 185.

⁵⁰ See generally William Davey, "European Integration: Reflections on its Limits and Effects" (1993) 1 *Global Legal Studies Journal* 185.

making. Article 54 provides for the drawing up of a general programme for the abolition of existing restrictions on freedom of establishment within the Community. Under art 54(3)(g) the Council and the Commission are instructed to carry out their duties 'by coordinating to the necessary extent the safeguards which, for the protection of the interests of members and others, are required by member states of companies or firms within the meaning of the second paragraph of art 58 with a view to making such safeguards equivalent throughout the Community.'

Article 100 is a general provision on approximation of laws. It provides that the Council shall, acting unanimously on a proposal from the Commission, issue directives for the approximation of such provisions laid down by law, regulation or administrative action in member states and directly affect the establishment or functioning of the common market. The Parliament and the Economic and Social Committee shall be consulted in the case of directives whose implementation would, in one or more member states, involve the amendment of legislation. Articles 100A and 100B which were added by the Single European Act provide for qualified majorities in certain cases.

Article 220 provides that member states shall, so far as is necessary, enter into negotiations with a view to securing inter alia the mutual recognition of companies or firms within the meaning of the second paragraph of art 58, the retention of legal personality in the event of transfer of their seat from one country to another, and the possibility of mergers between companies or firms governed by the laws of different countries; the simplification of formalities governing the reciprocal recognition and enforcement of judgments of courts or tribunals and of arbitration awards. These negotiations lead to international treaties which supplement the existing treaties. An example is the 1968 convention on mutual recognition of companies. Article 221 provides for abolition of all discriminatory provisions in the laws of member states with respect to equity participation in companies.

Lastly, art 235 contains sweeping-up provisions. If action by the EU proves necessary to attain one of the objectives of the EU and the Treaty of Rome has not provided the

necessary powers, the Council shall, acting unanimously on a proposal from the Commission and after consulting the Parliament, take the appropriate measures.

Patterns of legal integration

The three basic legal techniques of integration used are, therefore,:

- (1) the removal of all restrictions which discriminate on the basis of nationality including restrictions on freedom of establishment;
- (2) the putting into effect of common rules and common policies;
- (3) the approximation of national laws under art 3(h).⁵¹

The Treaty also uses the terms “harmonisation”, which English lawyers tend to prefer, and “co-ordination”, but there seems to be little consistency in the way in which they are used and there seems to be no meaningful difference between them.⁵² All three terms fall short of unification.

The usual pattern is for drafts of proposal to be prepared by the Commission. They may then be discussed in a group convened by the Commission and consisting of “experts” (ie officials) from member states and may be circulated by the Commission to interested outside bodies. After adoption by the Commission as formal proposals, they are sent to the European Parliament and the Economic and Social Committee for their opinions. In the light of these opinions the Commission may amend their proposals, before presenting them to the Council of Ministers for discussions in a working group of official from the various member states. Such discussions are normally chaired by officials from the member state holding the Presidency of the Council of Ministers. They are subsequently

⁵¹ See generally Richard Buxbaum and Klaus Hopt *Legal Harmonisation the Business Enterprise*, Walter de Gruyter, Berlin (1988) Chapters 3 and 4.

⁵² On Community policy with regard to approximation of laws, see the lecture given by Dr C D Ehlermann, Director General of the Legal Service of the Commission published in App3 (b) of the Lords Select Committee on the European Communities (‘HLSC’) (HL 131) (1977-78). See also Piet Jan Slot “Harmonisation” (1996) 21 E.L. Rev. 378 and Benjamin Lo, “Improving Corporate Governance. Lessons from the European Community” (1993) *Global Legal Studies Journal* 219.

referred to the Committee of Permanent Representatives (COREPER) which in turn refers them to the Council of Ministers itself for final decision.⁵³

Progress to Date

Within the EU, some progress has been made on three broad fronts. First, there are the directives prepared under the provisions of art 54(3)(g); secondly, there are treaties drawn up under art 220, and thirdly, there is a draft regulation providing a statute for a European company drawn up under art 235. Let us look at each of these in turn.

Although the EU has been successful in harmonisation of share capital, accounting and auditing it has not been particularly successful in the area of corporate governance. The relevant directives are as follows.

*The First Directive (68/151/EEC)*⁵⁴ This was adopted on 9 March 1968 and mainly provided for relief against the doctrine of ultra vires and limits of directors' authority as well as providing for some basic publicity. The Directive was implemented by the UK in s9 of the European Communities Act 1972 as amended by s.35A of the Companies Act 1989.⁵⁵

*Draft Fifth Directive*⁵⁶ This deals with the important topics of company structure and worker participation and has been the subject of much controversy.⁵⁷ The present position is that the Commission's modified proposal is under consideration by a Council

⁵³ This summary of procedure is taken more or less verbatim from *The Single Market – Company Law Harmonisation* published by the Department of Trade and Industry.

⁵⁴ 20 OJ, L26, 31 January 1977, pp 1-13.

⁵⁵ See DD Prentice (1973) 89 LQR 518; J H Farrar and D G Powles (1973) 36 MLR 270; J G Collier and L S Sealy (1973) CLJ 1. See now CA 1985, ss 35 and 25A. See *Farrar's Company Law* 4th ed, Chapter 10.

⁵⁶ This Directive was first proposed in 1972; see Official Journal of the European Communities 1972 No C 131/49. The current version is that put forward in 1991 (OJC 321/9 of 12 December 1991). See the Green Paper on Employee Participation and Company Structure in the European Communities, EEC Bull Aupp 8/75. See CM Schmitthoff [1983] JBL 456 and the memoranda of the Law Society's Company Law Committee of March 1984 and April 1990. For useful recent discussions see JJ Du Plessis and J Dine [1997] JBL 23.

Working Group of officials from the member states and the commission. It is anticipated that discussion of the draft will take several more years. The new draft provides for a distinction between directors of a public limited company who will be responsible for management and those responsible for their supervision. At the end of 1983, the Commission announced an alteration so that this distinction could be achieved either through a two-tier board or a conventional one-tier board as in the UK. On the one-tier board, there would be a division between executive directors who would manage, and non-executive directors who would supervise. The implementation of this distinction as a matter of law would require changes to English law.

Employee participation in corporate decision-making would be required to take one of the following forms.

- (1) through board representation at the supervisory level;
- (2) by means of a works council; or
- (3) through collective agreements giving the same rights as (1) or (2).

Further options are included in respect of employee participation in groups of companies.

In addition to these major provisions, the latest draft also includes provision in respect of (a) the duties and liabilities of directors; (b) the power of the general meeting; (c) the rights of shareholders and in particular minority shareholders; (d) approval of annual accounts; and (e) the functions and liability of auditors. With regard to (a) there is a general provision for personal liability for loss suffered by the company as a result of breaches of law, the corporate constitution or other wrongful acts. Liability is to be joint and several which would involve a change in English law and arguably lead to more effective monitoring of management by management. An individual director may be exonerated if he or she can prove that no fault is attributable to him or her personally. The draft does not define the standard of care required of directors although the

⁵⁷ See J Welch (1983) 8 ELR 83. See also W Kolvenbach (1990) 11 University of Pennsylvania J of International Business Law 709 at 720-733.

Commission's Explanatory Memorandum to the original proposal in 1972 suggested that 'other wrongful acts' might include negligence and would arguably go further than the current law. With regard to (b), shareholders are given slightly more rights in respect of the convening of meetings. As regards (c), arts 16-18 allow a minority shareholder to bring a derivative action on behalf of the company, even where the general meeting has expressly renounced its right to bring proceedings provided that the plaintiff shareholder voted against the resolution or made objection which was recorded in the minutes. Proceedings can be instituted by a simple majority of the shareholders or in the case of a derivative action by shareholders holding 5% of the issued capital or shares to the value of 100,000 ECUs. An unsuccessful shareholder who fails to establish reasonable grounds for commencing the proceedings may be ordered to pay costs. Under the original art 19, a derivative action could also be brought by a creditor who was unable to obtain payment and such an action would not be affected by any waiver by the company of a breach of duty. This has been deleted and replaced by a vague provision which leaves the matter to be determined by the laws of the member state.

Other important provisions prevent a shareholder from voting on an issue where there is a conflict of interest between the company and him or her personally. This would go further than the existing English law. Another provision renders void shareholder agreements whereby a shareholder undertakes always to vote in a certain way. This would involve an alteration of the English law. There are provisions for compulsory reserves and appropriation of profits. The latter would have the effect of shifting the power to determine dividends to the general meeting. Both of these would involve a change in English law.

We will not comment on the detailed provisions in respect of auditors and accounts.

In addition there is Directive 94/95/EC of 22 September 1994 on the establishment of a European Works Council and also a draft Directive on procedures for informing and

consulting employees which overlaps with the Fifth Directive. This is sometimes known as the Vredeling Directive.⁵⁸

Draft Ninth Directive This draft, which has never been officially published in the Official Journal, deals with certain aspects of the group relationship.⁵⁹ The preliminary draft was greatly influenced by the German law relating to groups. A revised text was circulated informally to member states in December 1984. The revised text seeks to provide an organised legal structure for the 'unified management' of a public limited company which is controlled by any other undertaking (whether a company or not) and of that other undertaking. The directive will also set out rules for the conduct of groups which are not subject to 'unified management' although in this case the rules would apply to the relations between the parent or dominant undertaking and those members of the group which are public limited companies. Unless the dominant undertaking formalises its relationship by one of the methods specified by the Directive it will be liable for any losses sustained by the dependent company resulting from that influence and attributed to a fault in management or to action which was not in its interests. There are to be two methods for constituting a group – the control contract or a unilateral declaration of control. In addition, the Directive would leave member states free to introduce other methods of achieving the same result.

*The Twelfth Directive*⁶⁰ This allows private companies with only one member. This was permitted already in a number of jurisdictions.

*Proposal for a Thirteenth Directive*⁶¹ This deals with takeovers and is influenced by the City of London Takeover Code. The proposal has been strongly attacked. The UK

⁵⁸ 26 OJ, C 217, 12 August 1983, pp 3-16.

⁵⁹ See F Woolridge *Groups of Companies* (1981); T Hadden *The Control of Corporate Groups* (1983), p 42; J Welch (1986) 7 Co Law 112; K Gleichmann 'The Law of Corporate Groups in the EC' in D Sugarman and G Teubner (eds) *Regulating Corporate Groups in Europe* (1990).

⁶⁰ 32 OJ 1989, L 395, 30 December 1989.

⁶¹ 23 OJ, C 64, 14 March 1989, pp 8-14; Amended Proposal (COM(90) 416 final), September 14 1990, OJ C 162/5 of 6 June 1996. See LS Sealy 'The Draft Thirteenth EC Directive on Take-overs' in M Anderras and S Kenyon-Slade *EC Financial Market Regulation and Company Law* (1993), ch 9; J Dine (1996) 17 Co Law 248.

Government is concerned that it is too inflexible and may inhibit takeovers. On the other hand, other member states have criticised it because it opens the door to hostile takeovers by blocking certain takeover defences. The position regarding takeover differs between member states. For example, in Germany the practice is for shares to be held by banks for their own account or for their clients and thus a takeover of a German listed company cannot be effected without the consent of the banks involved. An amended proposal was issued in 1996.

Secondly, there are international conventions. On 29 February 1968, the original member states of the EU other than the Netherlands signed the convention on the mutual recognition of companies and legal persons.⁶² The convention was to apply to all companies incorporated in any member state and would include an English partnership. Recognition was to be accorded when the company has its statutory registered office in one of the member states. This would be subject to certain exceptions based on the principle of the real seat. After much discussion, the member states have now decided to abandon the project. Mutual recognition occurs in practice anyway, without the necessity of a Convention.

A draft convention has been prepared dealing with bankruptcy, winding-up, arrangements, compositions and similar proceedings.⁶³ This supplements the convention on mutual recognition of judgments which has now been given internal effect by legislation.⁶⁴ It has undergone a great deal of revision, particularly as a result of UK membership. This in essence provides for the rationalisation of bankruptcy, winding up and analogous proceedings in the EU. First, it sets out detailed rules to enable bankruptcy jurisdiction to be vested in a single and appropriate national court. Secondly,

⁶² EEC Bull Supp 2/69; B Goldman *European Commercial Law* (1973), 389; GK Morse [1972] JBL 195.

⁶³ See Report of the Advisory Committee on the Draft Convention (Cmnd 6602). See also "Bankruptcy Convention" 26th Report (1980-81) of the HLSC (HL 175) (1980-81). See M Hunter QC (1972) 21 ICLQ 682, (1976) 25 ICLQ 310; I Fletcher (1977) 2 ELR 15, JH Farrar [1977] JBL 320; F Dahan (1996) 17 Co Law 181.

⁶⁴ The Convention on Jurisdiction and the Enforcement of Judgements in Civil and Commercial Matters, dated 27 September 1968 and amended on 9 October 1978 (1978) OJC 304, 30 October; (1979) OJC 59, 5 March.

it seeks to secure that the liquidator appointed by the court has extensive authority to administer the insolvent estate, wherever situation in the EU. Thirdly, it aims at simplification of the liquidator's duties in collecting assets and determining claims by a limited measure of harmonisation and identification of applicable law. Fourthly, it aims at simplification of the rules and reduction of the costs for a foreign creditor making a claim. The convention is likely to come into effect soon.

The last measure to be discussed is the most ambitious. This is the draft regulation for a European company.⁶⁵ The proposal goes beyond harmonisation and provides for an additional form of incorporation which will have registration with the Community. It will be available when two or more limited companies merge or form a joint holding or subsidiary company. Much work on this project was done by Professor Pieter Sanders of the Netherlands, although the French claim some responsibility for the paternity of the project. The project has been under debate for thirty years but acquired a momentum as part of the proposals for 1992. The Commission adopted an amended draft in April 1996 as a result of the report of a group of experts chaired by Etienne Davignon and this is the subject of a Consultative Document by the UK Department of Trade and Industry of July 1997.

The Future of Harmonisation within the EU

The tactics employed by the Commission have in the past been described as 'salami tactics'. In other words, they approached the matter slice by slice. This approach was criticised on the basis that it was difficult to agree upon any particular directive without knowing, at least in broad terms, what else was to be done. The counter-argument was that elaboration of a complete uniform Companies Act would take a lot of time and bog

⁶⁵ See *The European Company Statute*, A Consultative Document (July 1997), URN 97/786). See Report of the Select Committee on the EEC, HL. Session 1989-90, 19th Report (HL Paper 81-I); J Dine (1990); 11 Co Law 208. For some earlier discussion see 'Memorandum de la Commission de la CEE sur la creation d'une Societe commerciale europeenne' SEC (66) 1250 22 April 1966; 'Projet d'un statut des societes anonymes europeennes' Doc 16. 205/IV 66, December 1966; see generally *Quo vadis Jus Societatum?*, ed P Zonderland (1972) and *Farrar's Company Law* (op. cit) Chapter 43.

down reform within the Community for a long time. In any event, it has been said that the statute for the European company would provide some sort of blueprint.

In recent years there has been a suspension of work on certain projects and a determination to concentrate on certain key areas. Some real progress was made with company accounts and listing requirements. Work on the draft Fifth Directive has continued, although in its nature it is controversial. The key areas on which the commission is currently engaged are disclosure, corporate governance and its relationship to the draft Fifth Directive and the statute for a European company. With regard to disclosure, the Commission has participated in the negotiations in the ad hoc expert group on accounting on the United Nations Centre on Multinationals. On groups the original draft, based heavily on German law, has been the subject of controversy in other member states. This and codetermination have presented obstacles to the implementation of a number of other proposals, including the European Company Proposal. Dorresteijn, Kuiper and Morse in *European Corporate Law*⁶⁶ argue that the overall achievements of the harmonisation programme have been impressive, particularly when compared with other areas such as taxation, social policy and competition. Nevertheless, there are questions as to how the particular instruments of harmonisation have been used. First, directives tend to be over-specific and sometimes do not fit too well with national laws. Secondly, some directives, like the fourth and seventh, contain too many options. Thirdly, the harmonisation so far achieved has mainly related to the external structure of the company. Attempts to co-ordinate provisions relating to the internal structure have been unsuccessful. The two striking examples are employee participation and the law of groups. In this respect it is interesting to note the fact that the EU has to contend with a market based outsider model and a representation based insider model of corporate governance.⁶⁷ Attempts to super impose one over the other have failed for economic as well as social and political reasons.

⁶⁶ Adriaan Dorresteijn, Ina Kuiper and Geoffrey Morse, *European Company Law*, Kluwer, Deventer (1994), 64-6.

⁶⁷ For a discussion of these two models see OECD, *Financial Market Trends*, Paris 1995, 13 and Hans Blommestein, "The New Financial Landscape and its Impact on Corporate Governance" in M Balling et al. *Corporate Governance, Financial Markets and Global Convergence*, Kluwer, London 1998, Chapter III.

At the moment it is unclear whether the EU will continue its harmonisation programme. The other alternatives are systems of mutual recognition such as have been employed for the financial sector and other less formal methods of unification through the activities of private bodies and systems of self-regulation.

One thing is abundantly clear the area of least success in the EU program has been corporate governance due mainly to fundamental differences in national models and the context in which they operate.

THE CHARACTERISTICS OF THE GLOBAL CORPORATE LANDSCAPE

A working paper by three Harvard economists⁶⁸ on Corporate Ownership Around the World published by the National Bureau of Economic Research in 1998 set out some useful facts on corporate ownership around the world. These include:

- (1) The separation of ownership and control in listed public corporations is far from universal.
- (2) Many of the largest firms are controlled by families.
- (3) The widely held corporation is most common in countries with good regimes of shareholder protection.
- (4) Family control is more common in countries with poor shareholder protection.
- (5) State control is common, particularly in countries with poor shareholder protection.
- (6) In family controlled firms there is little separation between ownership and control.
- (7) Pyramids and deviations from one share one vote are most common in countries with poor shareholder protection.
- (8) Corporations with controlling shareholders rarely have other large shareholders.

⁶⁸ Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer *Corporate Ownership Around the World*, Working Paper 6625 National Bureau of Economic Research 1998.

Much of modern corporate governance theory has been premised on the Berle and Means⁶⁹ hypothesis of the separation of ownership and control. Berle and Means writing at the time of the first stock market crash argued that as companies got larger their shareholdings became diffused and in the resulting hiatus in significant power blocs management's power increased. This needed regulation by the courts or legislatures. What the results of this survey show is that we need to be more diverse and flexible in formulating models of corporations for the purpose of devising corporate governance structures, particularly at an international level. It is neglect of this fact until recently which has hampered the EU harmonisation program. Corporate governance necessarily reflects the corporate landscape in which it operates and we must resist a tendency towards ethnocentrism, particularly one centred on the USA simply because of its economic dominance. The USA has a number of path dependent characteristics which characterise its laws and which are not easily exportable or necessarily efficient.⁷⁰ It is the economic efficiency of US markets, not necessarily its legal system, which should be emulated.

Nevertheless, the South East Asian Financial crisis has exposed the dark side of corporate governance practices in some of the countries involved.⁷¹ Common features include complex systems of family control and the existence of conglomerate structures which often defy economic rationality; little or no effective standards to ensure controlling shareholders and management behave properly to small investors; an absence of transparency and proper auditing practices; inefficient and sometimes corrupt legal systems in some of the countries; a lack of integrity in the regulatory processes (if they

⁶⁹ Adolph Berle Jr and Gardiner Means, *Modern Corporation and Private Property*, Harcourt, Brace & World Inc, NY. Revised Edition 1968. For a more recent study see Margaret Blair *Ownership and Control. Rethinking Corporate Governance for the Twenty First Century*, The Brookings Institution, Washington DC (1995).

⁷⁰ See the valuable analysis by Mark Roe "Path Dependence, Political Options, and Governance Systems" in Klaus Hopt and Eddy Wymeersch, *Comparative Corporate Governance*, Walter de Gruyter, Berlin 1997, 165.

⁷¹ For a penetrating recent study see Michael Backman, *Asian Eclipse – Exposing the Dark Side of Business in Asia* John Wiley & Sons (Asia) Pte Ltd, Singapore (1999). Compare, however, Richard Appelbaum, "The Future of Law in a Global Economy" (1998) *Social & Legal Studies* 171 which argues the contrary.

exist) and the absence of an independent, proactive media. The notable exceptions are Singapore, Hong Kong and to a less extent Taiwan and Malaysia.

It has been argued⁷² that sustained prosperity depends on the following basic rules:

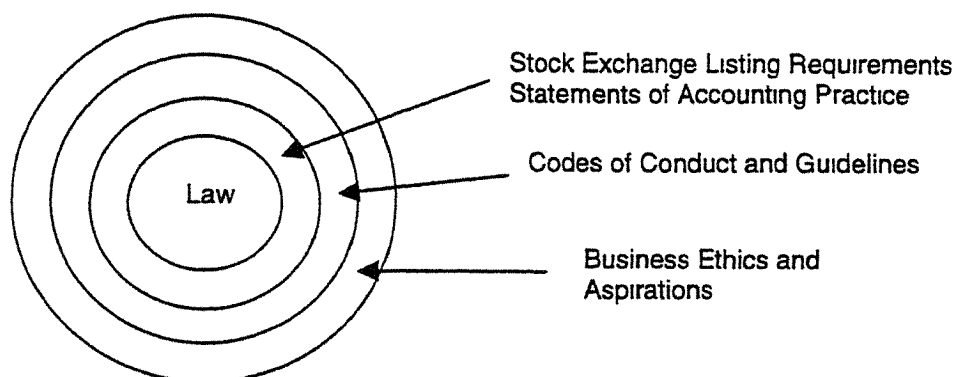
- effective standards of corporate governance;
- a high degree of corporate transparency and adequate external auditing;
- efficient stock exchanges;
- competitive markets;
- efficient and transparent legal frameworks;
- a clear distinction between regulators and regulated;
- independent, transparent and competitive banking systems; and
- a well resourced, inquisitive and independent media.

The South East Asian approach sowed the seeds of its own collapse.

THE EVOLUTION OF MODERN CORPORATE GOVERNANCE AND ITS PLACE IN A NEW FINANCIAL ARCHITECTURE

Our early ideas of corporate governance have been very much tied in with national models. Thus in a system characterised by one tier boards it makes sense to talk about more independent directors. In a system characterised by two tier boards the matter has been substantially catered for by a different mechanism. Nevertheless in the last twenty years we have seen an extension of the concept of corporate governance beyond national models of corporate laws to encompass systems of self regulation which differ in degrees of rigour and formality. The matter can be represented thus:

⁷² Ibid 3.



Corporate governance does not exist in a vacuum. Modern corporate governance is played out in the context of expanding and increasingly sophisticated capital markets. Within these markets institutional investors are now major players in western countries and are diversifying into international portfolios.

INSTITUTIONAL INVESTORS AND CORPORATE GOVERNANCE⁷³

Extent

Institutional investors increased their market share of UK-listed equities from 17.9% in 1957 to 60.4% in 1992, and are acquiring about 2% of the UK equity market each year.⁷⁴ Institutions hold over 60% of listed loan capital.⁷⁵ There are the highest international percentages but there are similar trends in Australia, New Zealand, Canada and the USA

⁷³ This is based on *Farrar's Company Law* 4th ed 578 et seq. For a magisterial study see John C Coffee Jr "Institutional Investors as Corporate Monitors: Are Takeovers Obsolete" in J H Farrar (ed) *Takeovers, Institutional Investors and the Modernization of Corporate Laws*, Oxford University Press, Auckland 1993, Chapter 2. See this also for citation of the many US Law review articles on aspects of this topic. See also GP Stapledon, *Institutional Shareholders and Corporate Governance* Oxford (1996); Ian Ramsay, Geof Stapledon, Kenneth Fong, *Institutional Investors' Views on Corporate Governance*, Research Report, Centre for Corporate Law and Securities Regulation, University of Melbourne 1998; G Stapledon, "The Duties of Australian Institutional Investors in Relation to Corporate Governance" (1998) 26 ABLR 331; Hans Blommestein, "The New Financial Landscape and its Impact on Corporate Governance" in M Balling et al (ed) *Corporate Governance, Financial Markets and Global Convergence* Kluwer, London (1998) Chapter III.

⁷⁴ RJ Briston and R Dobbins *The Growth and Impact of Institutional Investors* (1978) 24; GP Stapledon *Institutional Shareholders and Corporate Governance* (1996).

⁷⁵ J Coakley and L Harris, *The City of Capital* (1983), 106-7.

although each country has its own distinctive history.⁷⁶ These facts nevertheless potentially revolutionise the concept of corporate governance in those English speaking countries. Ownership is being regrouped but until recently has been relatively passive. The relationship between institutions and portfolio companies and between institutions and their constituents is not uniform and is in fact quite complex in those countries.⁷⁷ Whereas the separation of ownership from control is a relatively simple movement, this further stage of a regrouping of ownership and with the potential of control is not so simple. Yet its impact on our understanding of the listed company and the whole conceptual framework of company law is potentially profound. Hence one American writer, Paul Harbrecht, referred to the 'paraproprietal society'.⁷⁸ Since Harbrecht's time there has been the massive growth of funds managers who manage funds on behalf of the institutions. This complicates the picture further.

Reasons for the Growth of Institutional Holdings

The first and paramount reason for the growth of institutional holdings is the growth of pension and superannuation schemes since 1945. Originally in private pension plans, pension obligations were satisfied by the purchase of annuities from life insurance companies. Thus the funds were included in the insurance companies' assets. Later, non-insured plans became popular because of the possibility of investment of the fund in ordinary shares.

A second reason is the relaxation of the trustee investment rules by legislation in many countries which allowed trustees to invest part of the trust funds in equities.

⁷⁶ See J H Farrar and M Russell, "The Impact of Institutional Investment on Company Law" (1984) 5 Co Law 107; Coffee op cit. For recent surveys see *Australian Stock Exchange Fact Book 1998*, 17; Thomas Clarke and Stewart Clegg *Changing Paradigms – The Transformation of Management Knowledge for the 21st Century*, Harper Collins Business, London 1998, 314. The percentage for USA was 46%, Japan 45%, Germany 29%. In Japan and Europe a significant percentage was held by non financial enterprise.

⁷⁷ Farrar and Russell op cit; Stapledon op cit 239 et seq.

⁷⁸ 'Pension Funds and Economic Power: The Paraproprietal Society': Preface to DJ Baum and NB Stiles *The Silent Investors* (1965).

A third reason is the rise of insurance-linked investment schemes to take advantage of insurance tax relief in some countries although the modern tendency is to withdraw this relief to maintain a level playing field.

A fourth reason is the favourable tax treatment of insurance companies and unit and investment trusts in some countries.

A fifth reason is the deregulation of the banking and securities industries since the early 1980's and the removal of exchange control in a number of countries.

Lastly, there has been the impact of technological change and the change in international communications.

It is noticeable how none of these reasons is company-orientated. In other words, the company is simply the outlet for these investment urges. This, combined with the passivity of institutions as shareholders, probably accounts for the fact that until the 1980s such investment caught the corporate world unawares and company lawyers failed to appreciate its full significance. On the other hand the collapse of the Maxwell empire and the scandals surrounding use of pension funds for corporate purposes have put the spotlight on this legally complex area and led to the Report of the UK Pensions Law Reform Committee chaired by Professor Roy Goode in 1993. The report recommended a new Pensions Act and system of regulation to impose order on the chaos.

The Past Elusiveness of the Institutional Role in Corporate Governance

While the growth of institutional holdings and their potential power is well documented until the last decade there was little evidence that such power had been exercised in any significant way. One, therefore, hesitates to talk in terms of control except perhaps in the sense of constraint or power to monitor.⁷⁹

⁷⁹ Herman *Corporate Control, Corporate Power* (1981); cf Stapledon, *op cit*, chs 4, 5, 9 and 10.

Nowadays, however, there is direct and indirect industry-wide and firm-level monitoring. The direct monitoring is done by analysis of information and regular meetings and dialogue with management. Indirect monitoring is done by investment committees as well as support for non-executive directors.

In the UK, the two best documented cases of institutional intervention are the Thalidomide and the Newman Industries cases. In the former the management of Distillers Company Ltd foolishly resisted public pressure to settle on more generous terms with the victims. In the end, their shares fell and the institutional investors together with the company's merchant banks met senior management on 4 January 1973. Two days later, the company increased its offer from £3.24m to £21.75 m which formed the basis of the ultimate settlement.⁸⁰ In the Newman Industries case,⁸¹ the Prudential Assurance Co Ltd litigated in individual, representative and derivative form as a minority shareholder and the costs of the proceedings at the first instance were reported to be £¾ m. The case later went on appeal before being eventually settled. The judgment of the Court of Appeal was rather critical of the cost involved in their initiative.

In numerous cases, institutional support has assisted a bidder in a takeover bid. The main aim here has been gain. In the US, the SEC's Institutional Investor Study Report,⁸² documented institutional involvement in transfers of corporate control. They instanced the following as the two main strategies which had been adopted:

- (1) purchase of shares in anticipation of bid;
- (2) financial assistance to the bidder.

Amongst the special inducements which they have received in return for advance information about a bid were a higher price for their shares and assurances of contingent

⁸⁰ See the Times, 5 and 6 January 1973; *The Economist*, 6 January 1973, p 9; PI Blumberg *The Megacorporation in American Society*, Prentice Hall, Englewood Cliffs, NJ, 1975, 134-5.

⁸¹ *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204, CA. See also Vinelott J [1980] 3 WLR 543. See also (1980) Sunday Times, 24 February; (1980) Times, 19 June, (1981) Times, 31 July and 1 August.

⁸² House Doc 64 Pt 5, 92d Cong 1st Session, 2847-9.

benefits if the bid succeeded. In many countries use of advance information may now be caught by the insider trading provisions.

Dr G P Stapledon in *Institutional Shareholders and Corporate Governance*⁸³ has documented 18 areas of corporate governance where UK institutional investors or funds managers have been active, usually behind the scenes. These cover a wide range of corporate activity. Usually this monitoring takes the form of direct firm-level monitoring has taken place through various committees and by the use of non-executive directors.

Nevertheless the prevailing view hitherto has been that the primary responsibility of the institutional investor is simply to achieve maximum investment performance. If this is not present in a portfolio company the rule has been to sell. This rule has two aspects – first, it denies the existence of any duty to fellow shareholders and other groups such as employees and consumers and secondly, it maintains that in any event the overriding duty is to sell rather than incur costs and further risks.⁸⁴

Institutional investors in the past have been worried about the political consequences of an exercise of power. They eschew public criticism and fear public intervention. Some consider that their expertise is finance and investment rather than management and this does not necessarily equip them to pursue an interventionist role. They are also worried about the risks involved. Lastly, they are reluctant to offend the companies in which they invest. They may be more than one relationship between the company and institutions and in any event the institutions continue to rely on the companies for current information in spite of the new prohibitions on insider trading.

This conservatism of institutions in the exercise of power was criticised by Adolf Berle Jr in the following terms.⁸⁵

⁸³ Ibid Chapter 4.

⁸⁴ PI Blumberg, *The Megacorporation in American Society*, 136.

⁸⁵ Berle, *Power without Property* (1960) pp 55-56. See also E Herman and C Stafanda 'Proxy Voting by Commercial Bank Trust Departments' (1973) 90 Banking LJ 91. Cf Stapledon op cit.

In effect, the position of the institutional managers is that they will not exercise their voting power so as seriously to affect the choice or the policies of corporate managements. The individuals for whom the institutions are fiduciaries, holders of rights in pension trust, of shares in mutual funds, or of insurance policies, have surrendered their voting power. The institutional managers, therefore, by their policy of non-intervention, merely insulate the corporate managements from any possible action by or influence of the ultimate, beneficial 'owners' of the stock. A policy of non-action by the institutions means that the directors and managements of the corporations whose stock they hold become increasingly self-appointed and unchallengeable; while it continues, it freezes absolute power in the corporate management.

Institutional Investor Involvement in Self Regulation

In the last decade institutional investors have become more organised and have promoted law reform and the development of self regulation of corporate governance.⁸⁶ Carolyn Brancato⁸⁷ has identified five stages in US institutional investor activism:

- (i) social responsibility investing;
- (ii) fighting anti takeover initiatives;
- (iii) pressing for structural governance changes in portfolio companies;
- (iv) monitoring performance;
- (v) incorporating non financial performance issues into indicators of corporate performances.

Institutional investors are important shareholders and debt capital holders who are themselves subject to increasing monitoring of their investment performance. Their ever increasing holdings and increased competition for funds management give them powerful incentives to take a more proactive role. On the other hand their role is often subject to

⁸⁶ See Carolyn K Brancato, *Institutional Investors and Corporate Governance*, McGraw-Hill Companies Inc, Chicago 1997, Chapter 3.

⁸⁷ Ibid

fiduciary constraints and these is a potential clash between long term and short term objectives.

In the USA Calpers has taken a leading role. Networks of institutional investors and specialist advisory services have formed in the USA which facilitate institutions exercising their voting duties and organising coalitions on specific policies or issues. In the UK historically the Prudential Assurance Company has taken a leading role although not always with conspicuous success. Institutions have been active in the drafting and operation of the City of London Takeover Code and in the Cadbury, Greenbury and Hampel Reports on Corporate Governance. In Australia institutions have been represented on the Bosch Committee which produced *Corporate Practices and Conduct* and the Australian Investment Managers Association (now the Investment and Financial Services Association) have produced Guidelines.⁸⁸ We set out some of the leading examples in Appendix A to this paper. A criticism that is sometimes made about the self regulation so far evolving is that it concentrates on form rather than substance and puts the emphasis on process rather than the outcome.

A recent UK survey⁸⁹ has shown that “best practice” in corporate governance is generally being followed by institutional investors themselves with most companies having audit and remuneration committees although the incidence of nomination committees is lower than might be desired. Life assurance companies have the highest number of key board committees while the retail bank sector has the highest proportion of non executive directors.

There is frequent contact between international institutional investors and some degree of cooperation.

⁸⁸ See Stapledon op cit; Robert Monks and Nell Minow *Corporate Governance* Blackwell Publishers Inc, Cambridge Mass (1995).

⁸⁹ See Chris Mallin, “The Role of Institutional Investors in the Corporate Governance of Financial Institutions: the UK case” in Balling op cit (fn 65 ante) Chapter X. See too Ramsay, Stapledon and Fong op. cit fn 70.

Not a Universal Picture

So far we have concentrated on English speaking countries. The question arises as to whether this picture is universal. The answer quite simply is no.

Recent studies have shown that the role of institutional investor involvement in corporate governance is relatively recent on the European continent.⁹⁰ This is primarily due to the structural factors. In many continental European countries institutional investors are banks or part of a banking group and subject to greater restrictions than institutional investors and investment managers in the countries we have considered.⁹¹

Also in countries like Germany banks have played a different role in relation to shares in listed companies. Their role has often been more closely involved with major companies than their English speaking counterparts due to complex factors including corporate networks. Japan has its own distinctive Keiretsu system where banks are caught up in a spider's web of corporate networks.⁹² Both of these factors inhibit shareholder activism and a proactive role in reforming corporate governance.

THE RECENT INITIATIVE OF THE OECD

In 1996 the Council of the Organisation for Economic Cooperation and Development (OECD) commissioned a study of corporate governance to review and analyse international corporate governance issues and suggest an agenda and priorities for further OECD initiatives. This led to the setting up of the Business Sector Advisory Group on Corporate Governance, which produced a report – *Corporate Governance: Improving Competitiveness and Access to Capital in Global Markets* in April 1998. The chairman

⁹⁰ See Eddy Wymeersch, "A Status Report on Corporate Governance Rules and Practices in Some Continental European States" in K Hopt, H Kanda, M Roe, E Wymeersch and S Prigge (ed) *Comparative Corporate Governance: The State of the Art and Emerging Research*, Clarendon Press, Oxford 1998, Chapter 12 (d).

⁹¹ Ibid para 37.

⁹² See eg. Kenichi Miyashita and David Russell, *Keiretsu – Inside the Hidden Japanese Conglomerates*, McGraw Hill NY 1986.

was Ira Millstein and the other members were Michel Albert, Sir Adrian Cadbury, Robert Denham, Dieter Feddersen and Nobuo Tateisi.⁹³

The following were identified as key areas of common understanding:

- Corporate governance practices constantly evolve to meet changing conditions. There is no single universal model of corporate governance. Nor is there a static, final structure in corporate governance that every country of corporation should emulate. Experimentation and variety should be expected and encouraged.
- Corporate governance practices vary and will continue to vary across nations and cultures. We can learn a great deal from observing experiences in other countries.
- Corporate governance practices will also vary as a function of ownership structures, business circumstances, competitive conditions, corporate life cycle and numerous other factors.⁹⁴

There are, however, a few fundamental parameters:

- Increasingly, it is accepted that the corporate objective is maximising shareholder value, which not only requires superior competitive performance but also generally requires responsiveness to demands and expectation of other stakeholders.
- Increased transparency and independent oversight of management by boards of directors are the central elements of improved corporate governance.
- Board practice should be subject to voluntary adaptation and evolution, in an environmental of globally understood minimum standards.

⁹³ *Corporate Governance: Improving Competitiveness and Access to Capital in Global Markets, A Report to the OECD by the Business Sector Advisory Group on Corporate Governance, OECD Paris 1998.*

⁹⁴ *Ibid.*

- There are certain areas in which the adoption of universal rules is preferable (such as in accounting).⁹⁵

The Committee recommended the following agenda:

- (1) The definition of the mission of the corporation and transparency about non economic objectives.
- (2) Adaptable corporate governance arrangements.
- (3) The protection of shareholder rights.
- (4) The facilitation of active investing.
- (5) The alignment of shareholder and other stakeholder interests.
- (6) The recognition of societal interests.⁹⁶

As can be seen (1), (5) and (6) are crucially vague and represent something of a political agenda.

The main corporate governance reports to date have addressed such issues as:

- (a) the structure of the board and board committees and in particular the role of non executive directors.
- (b) Directors' remuneration.
- (c) The conduct of general meetings and managing shareholder relations.
- (d) The role of institutional investors.

A list of some of the major reports and their common content appears in Appendix B to this paper.

⁹⁵ Ibid para 8 et seq.

⁹⁶ Ibid 16 et seq.

The Committee set out perspectives for public policy improvement.⁹⁷ This would be characterised by

- (a) flexibility
- (b) consideration of regulatory impact
- (c) regulatory focus centred on
 - (i) fairness
 - (ii) transparency
 - (iii) accountability
 - (iv) responsibility

The report also refers to clarity, consistency and enforceability and stressed the need for accurate timely disclosure and protection against litigation abuse, corruption and bribery.

Flexible corporate laws and securities regulation were called for which clearly specified management's responsibilities and protected shareholder rights. Policy makers should encourage some degree of independence in the composition of company boards, sound audit practices and a level playing field for institutional investors to ensure competition.⁹⁸

Individual corporations should continue to strive for corporate governance "best practices".⁹⁹

The Report favoured further OECD efforts:¹⁰⁰

- (a) to formulate a public policy document setting out minimum standards of corporate governance.
- (b) to formulate a code of voluntary "best practice".

⁹⁷ Ibid 19-23.

⁹⁸ Ibid para 28.

⁹⁹ Ibid para 36. See Michael Almond and Scott Syfert, "Beyond Compliance: Corruption, Corporate Responsibility and Ethical Standards in the New Global Economy" (1997) 22 *NCJ Int'l L & Com Reg* 389.

¹⁰⁰ Ibid.

(c) to encourage common principles of disclosure.

The Report was followed recently by the formulation of draft Principles. These are set out in Appendix C to this Paper.

The principles fall under five broad headings.¹⁰¹ These are:-

1. The right of shareholders.
2. The equitable treatment of shareholders.
3. The role of shareholders.
4. Disclosure and transparency.
5. The role of the board.

The principles are built upon the foundations of shareholder protection and the residual monitoring role of shareholders. Therefore, minimal protection of shareholders is envisaged to protect the right of participation and exit. Exercise of voting rights is encouraged.

Fair treatment of shareholders is required. In particular self dealing and insider trading are to be prohibited.

The discussion of stakeholders is well meaning but necessarily vague. Yes, they have a place but not necessarily legal rights. Disclosure is axiomatic and should be timely and accurate and subject to annual independent audit.

The role of the board is similarly crucial but the OECD countries have diverse structures and practices. Nevertheless the accountability of the board is basic. Various responsibilities of the board are discussed including an overriding duties to act fairly

¹⁰¹ See the OECD Web site for the latest version of the draft: <http://www.oecd.org/daf/governance/dafgovernance>.

between different groups of shareholders and stakeholders and to assure compliance with the law.

The principles go before a meeting of Ministers in May. It is envisaged that there will be intensive collaboration with non member countries and cooperation with other international organisations, in particular the World Bank.

In a speech given at Seoul, Korea on 3 March 1999 Ms Joanna Shelton, Deputy Secretary General of the OECD said:

The OECD Principles could be just one part of a wider dialogue on various aspects of corporate governance, in workshops or conferences that would be organised on a regional basis or possibly in some other ways. We are very open-minded as to the ways in which further dialogue with countries beyond the OECD membership might proceed. Whatever form this co-operation may take, strengthening the corporate governance framework in countries around the world is now recognised as one key element in laying a strong foundation for the resumption of economic growth in Asia and elsewhere and for a more stable international economic system.¹⁰²

The report clearly envisages the OECD playing a leading role in developing norms of international corporate governance. As with the OECD's Guidelines on Multinationals such initiative is to be welcomed but the matter needs to be promoted by other international bodies such as IMF, the World Bank and the WTO because of their broader base. As we have seen the WTO has been favoured for the role of supervision in the new global financial architecture.¹⁰³

¹⁰² <http://www.oecd.org//newsandevents/release/sheltonseal.htm>. "The Importance of Corporate Governance in OECD and non OECD Economies. The Draft OECD Principles" – Opening Remarks.

¹⁰³ Ebert op cit (footnote 2 ante).

THE CONTRIBUTION OF GLOBAL CORPORATE GOVERNANCE TO NEW FINANCIAL ARCHITECTURE

To sum up, the primary goals of global corporate governance are to promote:

- (1) transparency in commercial dealings and financial transactions especially fund raising.
- (2) accountability through more efficient monitoring of management performance.
- (3) competition.

Given the present state of a diversity of models of corporate governance reflected in national laws which may gradually diminish with the growth of regionalism and the impact of globalisation there is much to be said for the development of voluntary norms of international corporate governance based on an emerging consensus. This can mirror the work already done in respect of international accounting standards.

Sir Ronald Hampel who chaired one of the recent UK committees has said:

I believe an umbrella set of governance principles internationally would be helpful, within which it would be possible for national environments and companies to develop detailed governance structures appropriate to their circumstances.¹⁰⁴

The advantages of this approach are:

- (a) it is evolutionary
- (b) it is more flexible than a more elaborate attempt at harmonisation of laws on a regional basis.
- (c) It transcends the nation state and regions and is evolved by the industry (using that term in a broad sense). It recognises that global convergence is not necessarily inevitable.

¹⁰⁴ Company Director February 1999, p 16 (Australia).

- (d) There is an absence of an appropriate international organisation to promote harmonisation or uniform laws. The United Nations has failed in its Code of Conduct for Transnational Enterprise. The OECD has been more successful but its membership is limited and somewhat eclectic.

The dangers of this kind of approach lie in:

- (i) the dominance of the debate by financial institutions in the West and its consequent ethnocentrism.¹⁰⁵
- (ii) the lack of effective enforcement mechanism.
- (iii) the tendency to concentrate on form rather than substance and process rather than outcome.
- (iv) the tendency to pursue fashions without any consideration of their efficiency in practice.

We live in a period of complex transition characterised by rapid change and it is difficult to monitor the effects of this change on the existing world order. There are two distinct schools of thought about an appropriate approach to dealing with this. One is a regulatory approach – a projection of national regulation into the international arena. The other is a free market approach – to leave the development to market forces.¹⁰⁶ The evolution of norms of self regulation of international corporate governance from initiatives such as the OECD's Principles represents a possible middle way – a non legal soft law¹⁰⁷ which can form the basis of a *lex mercatoria*¹⁰⁸ of this area. The Romans said 'Via media, via tuta' – the middle way is the safe way.

¹⁰⁵ For an interesting recent discussion of an attempt to export US Corporate Governance ideas to Germany see Thomas Andre Jr "Cultural Hegemony: The Exportation of Anglo-Saxon Corporate Governance Ideologies to Germany" (1998) 73 Tul L Rev 69.

¹⁰⁶ See Grundfest *op cit* (footnote 3 *supra*).

¹⁰⁷ For a distinction between hard and soft law and legal and non legal soft law see CM Chinkin, "The Challenge of Soft Law: Development and Change in International Law" (1989) 38 ICLQ 850, 851.

¹⁰⁸ See Hans-Joachim Mertens, "Lex Mercatoria: A Self Applying System Beyond National Law?" in G Teubner (ed) *Global Law without a State* Dartmouth, Aldershot 1997, Chapter 2.

At the present stage of development, to use the language of Jack Nicholson in a recent film, "This is as good as it gets".

APPENDIX

A. National Corporate Governance Materials

- US** General Motors Board Guidelines on Significant Corporate Governance Issues 1995.
Statement of Governance Principles
(California Public Employee Retirement Scheme CalPERS) 1996
- UK** The Role and Duties of Directors – A Statement of Best Practice, Institutional Shareholders' Committee London 1991.

Board of Directors, The Code of Best Practice (Report on the Cadbury Committee on the Financial Aspects of Corporate Governance) 1992
Directors' Remuneration: The Code of the Best Practice (Greenbury Report) 1995.
Corporate Governance: Final Report
(Hampel Report) 1998
- France** The Board of Directors of Listed Companies in France (Vienot Report) 1995.
- Canada** Guidelines for Improved Corporate Governance in Canada, Toronto Stock Exchange 1994.
- Australia** Corporate Practices and Conduct 1995 (Report of Working Group chaired by H Bosch).
- European Union** A Status Report on Corporate Governance Rules and Practices in some Continental European States by Professor Eddy Wymeersch of the University of Ghent in Klaus Hopt et al (ed) *Comparative*

Corporate Governance – The State of the Art and Emerging Research,
Clarendon Press Oxford 1998, 1045-1199

B. Common Content of National Reports

Mission of the Board of Directors

Board Membership

Selection

Selection of Chairman and CEO

Size of the Board.

Role of Non executive Directors.

Definition of Independence

Terms of office

Remuneration

Assessing performance

Relationships with Investors

Relationships with Senior Management Board Committee

C. The Draft OECD Principles of Corporate Governance

I. The Rights of Shareholders

The Corporate governance framework should protect shareholders' rights

A. Basic shareholder rights include the right to :

- (1) secure methods of ownership registration;
- (2) convey or transfer shares;
- (3) obtain relevant information on the corporation of a timely and regular basis;
- (4) participate and vote in general shareholder meetings;
- (5) elect members of the board; and

- (6) share in the residual profits of the corporation.
- B. Shareholders have the right to participate in, and to be sufficiently informed on, decisions concerning fundamental corporate changes such as:
- (1) amendments to the statutes, or articles of incorporation or similar governing documents of the company;
 - (2) the authorisation of additional shares; and
 - (3) extraordinary transactions that in effect result in the sale of the company.
- C. Shareholders should have the opportunity to participate effectively and vote in general shareholder meetings and should be informed of the rules, including voting procedures, that govern general shareholder meetings:
- (1) Shareholders should be furnished with sufficient and timely information concerning the date, location and agenda of general meetings, as well as full and timely information regarding the issues to be decided at the meeting.
 - (2) Opportunity should be provided for shareholders to ask questions of the board and to place items on the agenda at general meetings, subject to reasonable limitations.
 - (3) Shareholders should be able to vote in person or in absentia, and equal effect should be given to votes whether cast in person or in absentia.
- D. Capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed.
- E. Markets for corporate control should be allowed to function in an efficient and transparent manner.
- (1) The rules and procedures governing the acquisitions of corporate control in the capital markets, and extraordinary transactions such as mergers, and sales

of substantial portions of corporate assets, should be clearly articulated and disclosed so that investors understand their rights and recourse. Transactions should occur at transparent prices and under fair conditions that protect the rights of all shareholders according to their class.

- (2) Anti-take-over devices should not be used to shield management from accountability.

- F. Shareholders, including institutional investors, should consider the costs and benefits of using their voting rights.

II. The equitable treatment of shareholders

The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.

- A. All shareholders of the same class should be treated equally.

- (1) Within any class, all shareholders should have the same voting rights. All investors should be able to obtain information about the voting rights affiliated with all classes of shares before they purchase. Any changes in voting rights within or between classes of shares should be subject to shareholder vote.
- (2) Votes should be cast by custodians or nominees in a manner agreed upon with the beneficial owner of the shares.
- (3) Processes and procedures for general shareholder meetings should allow for equitable treatment of all shareholders. Company procedures should not make it unduly difficult or expensive to cast votes.

- B. Self-dealing and insider trading should be prohibited.

- C. Members of the board and managers should be required to disclose their material interests in transactions or matters affecting the corporation.

III. The role of stakeholders in corporate governance

The corporate governance framework should recognise the rights of stakeholders as established by law and encouraged active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

- A. The corporate governance framework should assure that the rights of stakeholders that are protected by the law are respected.
- B. Where stakeholder interests are protected by law, stakeholders should have the opportunity to seek effective redress for violation of their rights.
- C. The corporate governance framework should permit performance enhancing mechanisms for stakeholder participation.
- D. Where stakeholders participate in the corporate governance process, they should have access to relevant information.

IV. Disclosure and transparency

The corporate governance framework should ensure that timely and accurate information is disclosed on all material matters regarding the financial situation, performance, ownership and governance of the company.

- A. Disclosure should include, but not be limited to, material information on:
 - (1) The financial and operating results of the company;

- (2) Company objectives;
- (3) Major share ownership and voting rights;
- (4) Members of the board and key executives, and their remuneration;
- (5) Material foreseeable risk factors;
- (6) Material issues regarding employees and other stakeholders; and
- (7) Governance structures and policies.

B. Information should be prepared, audited, and disclosed in accordance with high quality standards of financial disclosure non-financial disclosure and audit.

C. An annual audit should be conducted by an independent auditor in order to provide an external and objective control on the way in which financial statements have been prepared and presented.

D. Channels for disseminating information should provide for fair, timely and cost-efficient access to relevant information by users.

V. The role of the board

The corporate governance framework should ensure strategic guidance and effective monitoring of the company by the board, and the board's accountability to the company and the shareholders.

A. Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company.

B. Where the board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly.

C. The board should ensure compliance with applicable law and take into account the interests of stakeholders.

- D. The board should fulfil certain key functions, including:
1. Reviewing corporate strategy, major plans of action, risk policy, annual budgets and business plans, setting performance objectives, monitoring implementation and corporate performance, and overseeing major capital expenditures, acquisitions and divestitures.
 2. Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.
 3. Reviewing executive remuneration.
 4. Monitoring and managing potential conflicts of interest of management, board members and shareholders including misuse of corporate assets and abuse in related party transactions.
 5. Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for monitoring risk, financial control, and compliance with the law.
 6. Monitoring the effectiveness of the governance practices under which it operates and making changes as needed.
 7. Overseeing the process of disclosure and communications.
- E. The board should be able to exercise objective judgment on corporate affairs independent of management.
- (1) Boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgment to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are: financial reporting, nomination and executive remuneration.
 - (2) Board members should devote sufficient time to their responsibilities.

- F. In order to fulfil their responsibilities, board members should have access to accurate relevant and timely information.

Shareholder Remedies

Mr. Say Goo



Shareholder Remedies

Minority shareholder protection in Hong Kong's owner-managed companies

In Hong Kong, there are a large number of small, owner-managed companies. The shareholders are often company directors, and there is no separation of ownership and management. A typical scenario is that the family business, perhaps founded earlier by the father, is incorporated and the shares held by the father and his children. The children typically become directors managing the business of the company. Some of these companies are listed on the stock exchange, but most of them are not.

These companies are particularly vulnerable to family disputes, which vary from arguments over the fair remuneration of family members, to sibling power struggles, to generational conflicts over the issue of succession. The problem becomes particularly acute as family businesses head into the third generation when ownership becomes more diffuse, and divergence of opinion and frequent shareholder disputes become more likely.

These disputes present some difficult issues for those involved in trying to resolve them. Often these owner-managed companies are run in an informal way without strictly following the requirements of the *Companies Ordinance* and the companies' articles of association. These disputes can also become very personal, and it is often difficult for the aggrieved shareholders to sell their shares as often there is not a ready market for them. The controlling shareholder will often offer a very low price to buy out the aggrieved shareholders. Unfortunately, the law at present does not offer a satisfactory solution.

Where the controlling shareholders/directors have run the business in disregard of the *Companies Ordinance* and their articles of association, they are often in breach of their duties as directors. However, since only the company can bring legal proceedings against the wrongdoers (the rule in *Foss v Harbottle*), and since the decision to initiate legal proceedings is taken by the

board of directors, the controlling directors are unlikely to sue themselves for wrongdoing. In these cases, although the minority shareholders may bring a derivative action on behalf of the company, the law relating to this form of action is rigid, old fashioned and the procedure is lengthy and costly.

Under *Companies Ordinance* s 168A, a shareholder can petition the court for a remedy if the affairs of the company are being, or have been, conducted in a manner unfairly prejudicial to the interests of the members generally or individually. This provision has proved to be more useful than the derivative action. However, as the petitioner often feels it necessary to make all sorts of allegations of unfairly prejudicial conduct, proceedings under s 168A can also be costly and cumbersome. Unfair prejudice cases which go to trial can last weeks rather than days, and the costs to the litigants and the taxpayer can be substantial.

Proposals for Reform

Shareholder remedy issues have recently been considered by the Law Commission in England and Wales (the Law Commission), and Ermanno Pascurto and Cally Jordan in the review of the Hong Kong *Companies Ordinance* (the review body). Having examined the problems and consulted widely, the Law Commission's primary conclusions are that: (i) the rule in *Foss v Harbottle* should be replaced by a simpler and more modern procedure for derivative action, (ii) that the court should be empowered to streamline minority shareholder litigation so that it is less costly and complicated, and (iii) that there should be self-help remedies (such as a right of exit or 'buy-out' remedy) to avoid the need for the shareholders to resort to the court to resolve disputes. The review body also recommends that there should be a statutory derivative action to replace the rule in *Foss v Harbottle*, and that there should be a statutory buy-out remedy. However, it also recommends that the unfair prejudice provision should be widened.

Modern Derivative Action

Derivative action is rarely used in Hong Kong.

However, there may still be cases where it would be appropriate for a derivative action to be brought, for example where there has been negligence falling short of serious mismanagement by directors. It is also generally thought to have a clear prophylactic effect. It would therefore be desirable to replace the complicated and unwieldy rule in *Foss v Harbottle* and its exceptions with a statutory derivative action as the Law Commission and the review body have suggested, and as has been done in many provinces in Canada, New Zealand, South Africa and Japan.

The Law Commission suggests that a new form of derivative action should be made available to a shareholder where the cause of action arises as a result of an actual or proposed act or omission involving negligence (whether the directors have benefited personally), default, breach of duty or trust by a director (or shadow and de facto director). To prevent any abuse by disgruntled shareholders, the complainant should be required to obtain leave of the court in order to continue the action beyond the preliminary stages. In deciding whether to grant leave, the court should take into account factors such as the good faith of the applicant, the interests of the company, the fact that the wrong has been or may be approved by the company in general meeting, whether the appropriate independent organ of the company has resolved not to pursue the cause of action, and the availability of any alternative remedy.

The review body also thinks that it is desirable to have a statutory derivative action, but having looked at derivative actions in Canada and the US, did not spell out the content of the derivative action to be adopted here. It would appear that something along the lines of the Canadian formula would be suitable for Hong Kong. Under the Canadian formula, a derivative action can be brought if (i) reasonable notice to the directors is given, (ii) the complainant is acting in good faith, and (iii) it appears to be in the interests of the corporation that the action be brought. This formula gives the court discretionary power to control the action and to prevent misuse of it, rather similar to the approach taken by the Law Commission.

Case Management by the Court

The main problem with minority shareholder litigation is the length and cost of trial proceedings. This is particularly so in shareholder petitions under s 168A.

At present the court will not make any order until the full case is heard. As the wording of s 168A is extremely wide, it allows the parties to allege unfair prejudicial conduct going back over many years. Prolific or weak allegations are often made by the parties. This results in complex, often historical and factual investigations, and causes delay and enormous costs.

It is essential for the conduct of such proceedings be controlled carefully. The Law Commission considers this problem at length. The review body only suggests the 'buy-out' remedy as an alternative to litigation. The Law Commission concludes that the way forward is to have efficient case management by the court, a principle which can usefully be adopted here in Hong Kong. First, the court can make more use of its power under *Rules of the High Court* O 33 r 3 to direct that preliminary issues be heard, or that some issues be tried before others. Thus, if the real issue is not whether unfair prejudicial conduct had occurred, but the value at which shares should be sold or purchased, it would save time and costs if the value of the shares is determined first on the assumption that certain unfair prejudicial conduct had occurred.

However, the court should also consider the danger that if it transpires that the conduct complained of had not been unfairly prejudicial, the costs of valuation will have been unnecessarily incurred. As regards trial of preliminary issues, great care will indeed be needed to ensure that it will shorten the proceedings.

Secondly, the respondent may apply to the court to strike out the petition under *Rules of the High Court* O 18 r 19(1). However, the striking out order is normally made on the basis that the factual allegations by the petitioner are true; the court cannot make a finding of facts. This obviously is unsatisfactory because the factual allegations may not be supported by evidence which can only be found in the main trial. At present, the court cannot call for evidence at the striking out stage. Thus, if the factual allegations support a petition, the case will go to the main trial. If the court is given power to call for oral evidence to examine the evidential basis for the allegations and see whether the allegations stand any real chance of being proved, and to remove those trivial or weak allegations, this will shorten and reduce the length and costs of such claims. Furthermore, if the court is given power to accept evidence that the defence has no realistic prospect of success, and to grant relief without the need for a full trial, the applicants ►

with a good case will be able to obtain relief more quickly.

Thirdly, the court should be empowered to adjourn the case to enable the parties to make use of alternative dispute resolution (ADR) in appropriate cases, for example where the grievances go beyond the pleaded allegations. Since it is desirable to keep family squabbles private, mediation and arbitration are well suited to settling disputes in family-controlled businesses. The Chief Justice can make rules for the use of ADR with provisions for reporting back to the court as to the outcome, and for restoring legal full proceedings should ADR prove fruitless.

Fourthly, the court should more actively exercise its power under *Rules of the High Court* O 38 rr2-3 to decide how facts are to be proved, for example, written statements of evidence which are not intended to be cross-examined by the other party may be used without calling witnesses in court, and expert evidence can be made by means of a written report. Costly time in court can be saved.

Fifthly, the court should be given powers along the lines of the English Draft Civil Procedure Rule 5.1 proposed by the Law Commission to exclude an issue from determination if it can administer substantive justice between the parties on the other issues and determining it would therefore serve no worthwhile purpose.

Sixthly, the court should be given power to order costs against the party whose allegations have not been successful. This will encourage parties to focus their claims and to leave out irrelevant or weak allegations. At present, under *Rules of the High Court* O 62 r 10, the court cannot order a successful party to pay the costs of an unsuccessful party in respect of an issue which had failed, unless that issue had been unreasonably or improperly raised by the successful party (see *Re Elgindata (No 2)* [1993] BCLC 119, CA (Eng)).

Reforming the Unfair Prejudice Remedy

Apart from more rigorous case management which will hopefully reduce the length of trials and their cost, the Law Commission has suggested some changes to the unfair prejudice provision which will simplify the proceedings.

Presumptions of unfair prejudice

A large number of unfair prejudice cases involve

exclusion of certain shareholders from participation in the management of the company. In these cases, it will speed up the process and cut costs if the shareholder is given a speedy and economical exit route. It should not be necessary for the petitioner to make many allegations showing unfair prejudice which will only prolong the trial. To achieve this, it has been suggested that there should be a statutory presumption that in such cases, the affairs of the company have been conducted in an unfair prejudicial manner, and that where the court orders the aggrieved party's shares to be bought out, those shares should be valued on a pro rata basis.

At present, in order to show that the petitioner should not have been removed from management, it would be necessary to establish that the case is a quasi-partnership and that there is a legitimate expectation of participation. This encourages the petitioner to delve into factual history which prolongs the trial. Thus, it has been suggested that it would be useful to base the presumption on objectively ascertainable and less disputable factors. As the presumption should only apply to owner-managed companies, the Law Commission has suggested the following factors or conditions: (i) the presumption should only apply to private companies limited by shares, (ii) the petitioner should hold, immediately before the exclusion, not less than 10 per cent of the voting rights capable of being exercised at general meetings of the company on all, or substantially all, matters, and (iii) all or substantially all of the members should be directors. Thus, with the presumption of unfair prejudice in such objectively ascertained circumstances, the petitioner will be able to get a 'buy-out' remedy speedily.

Winding up as a remedy in unfair prejudice petition

The other common problem with a petition under s 168A is that a just and equitable winding up order is often sought (or sometimes vice versa). At present, although the court has power to make any relief on an unfair prejudice petition, the power to make a winding up order is not regarded as one of the orders it can make. The just and equitable winding up order can only be made under s 177(1)(f) of the *Companies Ordinance*. There are cases which satisfy the unfair prejudice provision, but not the just and equitable winding up provision, and yet it would be sensible to wind up the company.

The Law Commission has suggested that in these cases, the clear inclusion of winding up as a remedy the court can order on the grounds of unfair prejudice, would give the court the maximum flexibility and avoid the complication of the petitioner having to petition on both sections in the same proceedings. The idea of subsuming the just and equitable winding up remedy under the unfair prejudice remedy was aired by the working party of the review body, but the review body recommends that the former be retained as a distinct remedy as it would be useful in cases of deadlock. It would appear that both the English proposal and the suggestion of the review body could be adopted for Hong Kong, as they clearly cover different situations.

Extending the Unfair Prejudice Remedy

The review body has suggested that (i) s 168A should be broadened to include conduct that is oppressive, unfairly prejudicial to, or that unfairly disregards, the interests of any security holder, director or officer, and (ii) the remedy be available to a broader class of persons to include any registered holder or beneficial owner and any former registered holder or beneficial owner of a security of the company or any of its affiliates, any director or officer or former director or executive office, and curiously the Financial Secretary as the Financial Secretary already has the right to petition under the present provision.

Giving the right to petition to registered security holders (which includes a debenture holder) of the company or its affiliates and directors or officers, past and present, would indeed widen the scope of the provision tremendously. There is unfortunately very little discussion and analysis of the justification for and on the likely effect of this wide proposal by the review body. The Law Commission has considered the possibility of giving the right to petition to former members in its consultation paper and concluded in its report against such an extension. It points out the undesirable risk of increased litigation if former members were permitted to sue.

Self-help and Prevention

In most shareholders' disputes in small owner-managed companies, the shareholders are looking for ways to part company. The Law Commission suggests that the current costly and time-consuming litigation facing minority shareholders seeking an exit from the

company can be reduced if companies' articles of association were to provide such an exit in specified circumstances. The exit rights can be given to holders of particular shares by ordinary resolution, and every shareholder who is to have or be subject to the rights must be named in the resolution and must consent to it. This will ensure that only those shareholders who are aware of the exit rights and have consented to them will be bound by them. The right can be exercised by service of a notice requiring those on whom it was served to purchase the shares of the outgoing shareholder within a specified period of time, say, three months.

The review body has also made a similar suggestion to provide for a statutory 'buy-out' remedy. Its suggestion is based on the Canadian model under which the right is triggered by one of a number of fundamental changes, namely (i) the sale of all, or substantially all, of the assets of the business, (ii) mergers, (iii) changes in the business of the company, (iv) emigration by the company, and (v) a variation of share provisions. While the idea of the Canadian model is similar to the English proposal, these triggering events do not cover unfair prejudicial conducts by the majority.

It would also appear desirable to include a provision in the article for any dispute to be resolved by arbitration, and for arbitration to be suspended if the parties sought to resolve the dispute through ADR.

Conclusion

While the review body has looked into the problem of shareholder remedies, many pertinent issues mentioned above have not caught its attention. It is perhaps fortunate that the Law Commission has also recently reviewed shareholder remedies in detail and has discussed problems which are common to both jurisdictions (as Hong Kong existing law in this area is practically identical to the English one). It is hoped that the suggestions of the Law Commission will be taken into account when the Hong Kong legislature gets around to considering reform in this area.

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**Global Importance of Financial Sector
Reform in Japan**

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University of Hong Kong Faculty of Law
International conference on "New International Financial Architecture"
June 4-5, 1999

Global Importance of Financial Sector Reform in Japan

May 24, 1999
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The University of Tokyo

Abstract

The astonishing speed of globalization of financial markets inevitably affects, and is affected by, Japanese financial markets and Japanese financial institutions. Globalization of financial markets does not mean that there is one market on the earth. It means that many markets coexist in a multi-layer fashion, from a local domestic market to an international wholesale market. These multiple markets interact with one another. Also, financial transactions take place across country borders and financial institutions act across country borders in these multi-layer markets. Under this environment, a risk arisen in one market can easily be transmitted to another market, but from a regulatory standpoint, it is difficult to regulate these multi-layer financial markets.

This paper examines the impact of "Japan's Financial Big Bang" on the Japanese legal system and global financial markets. Japan's Big Bang, which was announced in November 1996, suggests a drastic move in the Japanese regulatory and institutional settings in the financial sector toward the Western model, particularly the American model, with the increased weight of capital markets in resource allocation. This move also suggests a change in the Japanese legal system. Exactly in what direction and to what extent the Japanese legal system will change, however, is a separate and difficult question. Also, how will the reform in Japan affect Asian and other world financial markets is another important issue.

This paper basically makes two arguments. First, Japan's Big Bang program in some respects serves as a force to change the entire legal system in Japan. Second, the increased competition brought into the market place as a result of Japan's Big Bang suggests a shift in regulatory focus toward interdependence among markets and market participants across country borders, rather than domestic markets and financial institutions.

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I. Introduction

The astonishing speed of globalization of financial markets inevitably affects, and is affected by, Japanese financial markets and Japanese financial institutions. Globalization of financial markets does not mean that there is one market on the earth. It means that many markets coexist in a multi-layer fashion, from a local domestic market to an international wholesale market. These multiple markets interact with one another. Also, financial transactions take place across country borders and financial institutions act across country borders in these multi-layer markets. Under this environment, a risk arisen in one market can easily be transmitted to another market, but from a regulatory standpoint, it is difficult to regulate these multi-layer financial markets.

The interaction between Japanese and global financial markets is not entirely clear. In December of 1989, a historical drop in stock prices on the Tokyo Stock Exchange began. Accelerated by the discovery of the "loss compensation scandal" in 1991,^{<1>} the stock price decline led to a sixty percent drop in the market in 1995.^{<2>} This market decline spread to real estate and other financial markets, and led to the worst banking crisis in Japan's history, driving the real economy into recession. Although this bursting of the stock market and real estate "bubbles" resulted in unheard of damage to Japanese institutions and the national economy, it did not spread to other countries' markets.

From a Japanese perspective, however, the competitiveness of Japanese financial institutions and Japanese financial markets inevitably declined.

Elsewhere I examined the Japanese response until 1996, and made the following tentative conclusion: (1) a country which suffers from scandals, market crashes or unfavorable economic conditions within the country has a stronger stimulation to move toward "global standards"; (2) the speed of a particular country's move toward these standards depends on its domestic

situation; and (3) what is happening is not that everything is moving toward these global standards.<3>

In this paper, I describe the developments in Japan since 1996. More specifically, this paper examines the impact of "Japan's Financial Big Bang" on the Japanese legal system. Japan's Big Bang, which was announced in November 1996, suggests a drastic move in the Japanese regulatory and institutional settings in the financial sector toward the Western model, particularly the American model, with the increased weight of capital markets in resource allocation. This move also suggests a change in the Japanese legal system. Exactly in what direction and to what extent the Japanese legal system will change, however, is a separate and difficult question. Also, how will the reform in Japan affect Asian and other world financial markets is another important issue.

In this paper I focus on these issues. I basically make two arguments. First, Japan's Big Bang program in some respects serves as a force to change the entire legal system in Japan. Second, the increased competition brought into the market place as a result of Japan's Big Bang suggests a shift in regulatory focus toward interdependence among markets and market participants across country borders, rather than domestic markets and financial institutions. Section II provides a brief sketch of the Big Bang's program. Section III examines its impact on the Japanese legal system. Section IV discusses the issue of interdependence among markets and market participants in the world. Section V is my preliminary conclusion.

II. Overview of Japan's Big Bang Program

1. Background

"Japan's Big Bang" is a program to undertake an extensive overhaul of the regulatory and institutional structure regarding the financial sector in Japan. The program was launched on the initiative of Prime Minister Ryutaro Hashimoto in November, 1996. He pointed out three fundamental principles for the program: free, fair and global. The reform is expected to be accomplished by the year 2001.

The Japanese economy suffered from the bursting of the "bubbles" in the stock and real estate markets in 1991. The stock prices dropped more than 60% between 1991 and 1995, and the land prices recorded a similar drop, driving the Japanese economy into recession. As a result, financial institutions and financial markets in Japan lost competitiveness. In Japan, the process of deregulation and the proper response to the rapidly changing environments in the world financial markets were delayed because the Diet and the government had to spend (and are still today spending) an enormous amount of time resolving the banking crisis. The Big Bang program is aimed at remedying this delay, and thus has two notable characteristics: (1) the reform

is drastic and the scope of the reform is extensive, and (2) the time-table of the reform is specifically shown.

2. Selected Items of the Big Bang Reform

While this is hardly the place to describe the detailed content of the Big Bang program, several items of the reform may be worth brief mentioning.<4>

Lifting ban on pure holding company (effective, December 1997 for non-financial firms; March 1998 for financial institutions). Anti-Monopoly Act, which per se prohibited "pure holding companies," was amended in 1997, and relevant statutes in the financial sector were amended to respond to this change. Thus, a financial group may emerge with a holding company structure where banking, insurance and securities businesses are offered through subsidiaries under centralized management of a holding company. In fact, Daiwa securities group established a holding company structure on April 26, 1999.

Abolishment of exchange control (effective, April 1, 1998). Foreign Exchange Act was drastically amended. For instance, anyone may open and maintain a bank account outside Japan without regulatory permission or clearance. Part of the individuals' financial assets in the total amount of U.S. \$10 trillion in Japan may move outside of Japan.

Abolishment of regulation on currency exchange business (effective, April 1, 1998). Also, as the result of the Foreign Exchange Act amendments, anyone may engage in the currency exchange business. Seven-Eleven type stores and other firms already announced entry to this business. For instance, travelers can buy U.S. dollars at the counter of the air carrier.

Establishment of new regulatory bodies (effective, June 22, 1998). A new agency called Financial Supervisory Agency ("FSA") was established and given power to regulate banks, securities firms, and insurance companies. This power was transferred from the Ministry of Finance to the FSA. Also, in December 1998, a new agency called Financial Rehabilitation Committee ("FRC") was established on the top of the FSA, and it was responsible for licensing and other regulatory activities in the financial sector. The FSA engages in the implementation of financial regulation. The creation of this new regulatory structure suggests that the style of financial regulation in Japan will also change: from consensus-based regulation to rule-based regulation.

Abolishment of fixed commission system of securities brokers (partly effective, April, 1998, full abolishment on October 1, 1999). This will inevitably make the securities brokerage industry more competitive.

Entry into securities business: from licensing system to registration system (effective, December 1, 1998). The entry level became lower for the

securities business. This change also accompanies the abolishment of prohibition on securities firms from engaging in a non-securities business. For instance, a manufacturer will be permitted to engage in a securities business while maintaining a manufacturing business. The number of securities firms may increase drastically.

Sale of mutual funds by banks (partly, December 1997, fully effective, December 1, 1998). Only 4% of U.S. \$10 trillion individuals' financial assets in Japan are invested in mutual funds in Japan. Sixty-five percent are invested in bank deposits and postal service deposits. When mutual funds become marketed by banks, the picture may drastically change. Also, important reforms for the mutual fund system were made. For instance, a company-type fund (which is popular in the U.S. but was not permitted in Japan) became available (effective, December 1, 1998). Also, private funds (funds marketed to a limited number of institutions) became permitted (effective, December 1, 1998).

Asset management by securities firm (effective, December 1, 1998). Securities firms are now permitted to offer the asset management service, typically by offering a product known in the U.S. as a "wrap account."

Improvement in accounting. Consolidated accounting with market value accounting of financial assets will be required. The new accounting rule must be consistent with the International Accounting Standards (effective FY 1999).

Defragmentation among banking, securities and insurance businesses. This is the ongoing liberalization program of fragmented industry regulation in Japan. Liberalization measures include permitting mutual entry among banking, insurance and securities businesses through the subsidiary or holding company structures, and reducing firewall regulations among banking, securities and insurance businesses. Implementation dates vary, but the most part will be completed on October 1, 1999.

Securitization of loans, receivables and real property. A special statute was passed in the Diet in June (effective, September 1, 1998). This special legislation permits a low-cost method of securitizing financial assets, so that financing in the capital markets will become more attractive. Also, of importance in this connection is the fact that the secondary market of securities among institutions was liberalized: certain qualified institutions may trade (non-equity) securities freely among themselves as under Rule 144A of the Securities Act of 1933 in the U.S. (effective, June 1998).

3. Impact on the Japanese Economy

While the impact of the Big Bang on the Japanese legal system is addressed in Section III, brief notes on the possible impact of the reform on the

Japanese economy may be worthwhile.

From Bank Centered System to Capital Market Centered System. In the past, bank lending dominated the financial sector in Japan. This infrastructure successfully helped Japan catch up and undertake high economic growth during the thirty years following World War II. Once the Japanese economy reached a matured stage, however, the bank centered system began to produce costs to the national economy due to the relatively high cost of banking services. Other major countries, notably the U.S., today have well-developed capital markets, and the globalization of financial markets inevitably requires the increased role of capital markets in Japan. The Big Bang program thus encourages drastic improvement of the Japanese capital markets.

From Stability to Adaptability. Related to the above, in the past, the Japanese system emphasized on stability, especially employment stability. This policy again made great contributions to Japan's economic growth. Stability, however, is not compatible with adaptability, and thus Japan was poor at adapting rapidly to changing environments in the world financial (especially capital) markets. The U.S. system, in contrast, represents a system emphasizing adaptability. The Big Bang program includes various measures toward increasing adaptability of the financial system in Japan. The price may be some loss in stability.

Increased Choice for Consumers. As the Big Bang includes drastic deregulation in the financial sector, it obviously will give Japanese consumers and investors more choice.

Increased Business Opportunities for Foreign Institutions. Obviously, the Big Bang will open more doors to foreign institutions. Some name the Big Bang reform as a "Wimbledon" style reform. While Wimbledon is located in the UK, most players are foreigners. Whether this will happen depends on language, business custom and other cultural contingencies.

III. Impact on the Legal System in Japan

1. Characteristics of the Japanese Legal System

While many characteristics were pointed out about the Japanese legal system in the past decades, I think that three distinctive features existed during the period when Japan made high economic growth after World War II: (1) solid basic laws, (2) strong bureaucracy, and (3) small judicial system.<5>

Solid Basic Laws Japan imported basic statutes in early Meiji era from Europe, and thus prepared "solid" basic statutes as early as in the late 19th century. Japan enacted basic statutes such as Civil Code, Commercial Code, Civil Procedure Code, and so on. Japan also prepared a Western-style

solid judicial system, including the court system. While how these imported components of the legal infrastructure contributed high economic growth in Japan may be a separate question, it is noteworthy that the process of these imports was rather smooth and Japan was quite successful in the transplantation of the Western legal system in the basic components of its legal system.

Strong Bureaucracy Aside from the existence of solid basic laws, however, it must be noted that strong bureaucracy played a significant role during the post-war high growth period. Japanese economy, including the financial sector, was controlled, protected and was carefully taken care of by the government which was armed with very strong bureaucracy. Universities successfully sent their good graduates to the central bureaucracy in the government, and rules made by, and developed under the initiative of, this strong bureaucracy governed the business and financial sectors in Japan, which in turn led the Japanese economy to unprecedented success.

Small Judicial System Under the above-mentioned circumstances, while the judicial system was kept solid since its inception in Meiji era, the actual role or activity of the judicial sector remained "small." The business sector, including the financial sector, developed rulemaking and dispute resolution mechanisms within themselves and without resorting to courts or the judicial sector. Most bureaucratic rules were promulgated by business participants and bureaucrats, and were almost never challenged before the courts. Also, disputes tended to be resolved within the business sector under the influence of strong bureaucracy, rather than by means of court litigation. As a result, the national budget allocated to the judicial sector was very small, and the number of judges and private attorneys remained small in Japan, compared with other major industrialized countries.

2. Impact of the Financial Big Bang on the Legal System in Japan

As noted in Section II, the Big Bang reform indicates that the style of financial regulation will change: from consensus-based regulation to rule-based regulation. On the one hand, drastic deregulation will permit financial institutions and other private parties great freedom in creating and offering new and innovative financial products in the market place. Ex ante prohibition for certain risk-bearing financial products will be lifted. On the other hand, rules will be enforced rather ex post, that is, the key to the new system is that the party who violates a rule will be sanctioned ex post. This change suggests a change in the three features of the legal system identified above. I describe the expected change in the reverse order: the judicial system, bureaucracy, and the basic law.

First, the judicial system must become larger. This must take place simply to respond to the rule-based system of finance. The effort in increasing the number of those who pass the national bar examination in recent years is

just one indication for the change. The number of lawyers will, and must, increase drastically. Also, the number of court litigation in the finance and business areas is already increasing, and today, judges are required the increased amount of knowledge and experience about complex financial transactions. For instance, in a recent case, judges faced the need for calculating damages in complicated swap transactions. More generally, both the court system and alternative dispute resolution systems should expand in response to increasing "legal" disputes in the finance and business areas. The government will have to allocate more budget and resource to the judicial sector.

Second, while I am not sure the power of the Japanese bureaucracy will become weak in the future, the style of bureaucratic governance will inevitably change. In the past, bureaucratic rules were promulgated by means of lengthy rulemaking processes. The Big Bang basically announced the abandonment of these rules; for the future, there will be the increased amount of straightforward "conduct" rules for market participants, which must be enforced ex post. This does not mean that regulators will become unimportant. They will remain important, but the style of regulation will change: from ex ante regulation to ex post regulation. The role of regulators will be to police compliance with rules, and to detect and sanction when rules are violated. In this vein, the role of the courts will inevitably become important. To take one example, the Securities and Exchange Act in Japan has a provision that the regulator may seek an injunctive order before the court to stop any illegal activity (section 192). This provision has never been triggered in the past. In the future, the provision of this type should be triggered in Japan.

Third, what about "solid" basic statutes? I predict that Japan will need more specific legal rules on the basis of the existing solid basic laws. To take one example in the finance area, Japan enacted a special statute in June 1998 (as a part of the Big Bang program) that confirms the validity of so-called close-out netting agreements popularly used in swap transactions worldwide. This legislation is already popular in the U.S. and Europe, and shows a new trend in the Japanese legislative history: enhancing legal predictabilities (or reducing legal uncertainties) in the finance area. The package of new statutes that was enacted in October 1998 to deal with the banking crisis includes various special provisions to the general rules on mortgage and related matters under Civil Code and related basic statutes. Thus, I expect that Japan will build up more intricate specific rules above the existing solid basic statutory base in the future.

3. Where Will the Japanese System Go?

As described above, Japan's Financial Big Bang suggests an extensive change in the Japanese legal system in certain important respects. Does this suggest that the Japanese legal system will converge to the Western

system? This is not an easy question to answer. Elsewhere I examined whether substantive legal rules on corporate governance converge.<7> There, the hypothesis was submitted that the cost of enforcement is the key and that in any given jurisdiction, unless various enforcement mechanisms change, substantive legal rules on corporate governance will not change, except for the rules of which the cost of enforcement is very low or too high. Japan's Big Bang will probably require the increased role and function of legal rules. Whether the Japanese legal system as a whole will change, and more generally whether legal systems in countries experiencing a similar reform in the financial regulation will converge, are both interesting questions worth future research.

VI. Global Implications

The essence of Japan's financial Big Bang is drastic deregulation of the financial sector, and this will bring more competition in Japan and world financial markets. As noted at the outset of this paper, globalization of financial markets does not mean that there is one market on the planet. It means that many markets coexist in a multi-layer fashion, from a local domestic market to an international wholesale market, and these multiple markets interact with one another. Also, financial transactions take place across country borders and financial institutions act across country borders in these multi-layer markets. Under this environment, a risk arisen in one market can easily be transmitted to another market, but from a regulatory standpoint, it is difficult to regulate these multi-layer financial markets.

1. Interdependence Among Market Participants

Japan's Big Bang will bring more freedom and competition among market participants both in and outside Japan. This will increase the degree of interdependence among market participants. One possible regulatory concern is systemic risk. Systemic risk is the expectation or the danger that a financial institution, typically a bank, fails to settle because another financial institution fails to settle. This risk typically exists in large-amount payment transactions among banks. But payment is not the only area where systemic risk exists. Such risk also exists in money market and securities transfer transactions, and, in theory, in other general financial transactions as well. There are many trade clearing and settlement systems for funds, securities, futures, options, and other financial instruments, all of which give rise to systemic risk. Any mechanical breakdown, liquidity problem or default in one of these systems would affect all direct and indirect participants in the system and could spread rapidly into other systems. As compared with payment systems, clearing and settlement systems for securities, futures and options have a complexity in their legal, structural and operational characteristics. Moreover, a bank, for instance, engages, as the same single legal entity, in many different types of transactions which go beyond various payment transactions to traditional lending transactions. Also, in countries where banks are permitted to do

securities business, a bank is involved in the delivery process of a wide range of securities. Thus, for instance, if a bank fails because of unwise lending, this failure would directly affect its ability to settle in payment and other transactions, which in turn could have widespread effects elsewhere.

Systemic risk is of particular importance in international financial transactions for at least four reasons. First, in modern financial markets, the same single bank simultaneously participates in different payment, money market and securities transfer systems, and these systems have different sets of legal, structural and operational characteristics. This simple fact aggravates the problem. Second, a local bank in Japan, for instance, one which has relatively weak credit standing, participates in international payment and other transactions through a correspondent "money center" bank, and this structure increases the degree of interdependence among the participants, which in turn makes systemic risk more serious. Third, time-zone differences cause problems, typically known as the Herstatt risk. Fourth, differences in the central bank's policies in various countries may also matter.

Systemic risk can be unbundled into four components or "sub-risks": pure credit risk, interdependence risk, time risk and large-amount risk. Pure credit risk is credit risk in the conventional sense, without taking into account the other three sub-risks. Of particular importance are the economic factors producing these three sub-risks, all of which are essential characteristics in modern financial transactions. Interdependence among participants is important because one bank's failure to settle causes another bank's failure to settle, and in that way one bank's failure to settle can have endless effects. In other words, a bank might depend on receiving a large credit from another bank in order to meet its obligations to other banks. Time is important because payment and other transactions are subject to a relatively short time constraint, and some mechanical breakdown or one bank's failure will give rise to the liquidity problem for other banks. It might be extremely costly for those other banks to find sufficient funds to meet their obligations in the time remaining before the settlement. A large trade amount causes the liquidity problem to the extent that it remains unsettled. Thus, time causes problems in two opposing ways. Time constraints for settlement produce the liquidity problem, but if the time remaining before the settlement is long, it produces a large unsettled amount.

The reality in today's financial markets is that the volume of each payment and other financial transactions tends to be quite large, and each transaction takes place with certain time constraints for settlement. The risk associated with large unsettled amounts exists unless settlement occurs immediately upon the transaction.

Also, the number of participants in each transaction increases. Take a typical example. Japanese companies often obtain funds by issuing bonds with stock purchase warrants in the Euro-market in U.S. dollars. Because they

ultimately want Japanese Yen, they need a currency swap arrangement. To do so, a bank becomes involved as an "extra" party. Thus, an increased number of parties become involved in the normal capital formation process, and consequently, the degree of interdependence among the parties increases.

In today's financial markets, there is demand among market participants to engage in transactions producing the four component sub-risks identified above. The benefits that would stem from any type of regulation must be weighed against the associated costs. Confining pure credit risk, time risk or large-amount risk would harm, rather than benefit, the market participants. That systemic risk exists does not itself justify regulation. Moreover, to what extent to reduce the risk is open to question. In theory, there existed systemic risk two decades ago, but it was not a problem then.

Controlling time risk or large-amount risk should be delegated to the market, where the participants can best deal with the problem. Whether pure credit risk should be controlled by regulation has been the fundamental issue in bank regulation, and this question is beyond the scope of this paper. Suffice it to say here that systemic risk is insufficient to justify the stronger regulation of pure credit risk.

Interdependence risk justifies some degree of regulation for two reasons. First, interdependence produces what economists call externalities. Each participant faces risk that can be originated and expanded in a party with whom it does not deal directly. It is extremely difficult and therefore costly for each participant to obtain information as to both where in the "chain" of participants the problem exists and how serious it is. This may justify regulatory intervention. Second, under current law in most countries, there may be a discrepancy between economic and legal interdependence. Specifically, current laws on setoffs and bankruptcy may not mirror economic interdependence. For instance, when two banks enter into dozens of foreign exchange executory contracts, economic interdependence is the outstanding or unsettled net amount they are obliged to pay to each other. But it is unclear whether current bankruptcy law recognizes this. Even if two parties explicitly agree to net out their obligations, it is unclear in some jurisdictions whether such a private agreement is enforceable when one of the parties goes into bankruptcy.

It follows that interdependence among market participants should be the key to justifying regulation, and current legal rules on bankruptcy and setoffs should also be reconsidered in this respect. Interdependence risk should be given more direct attention. Viewed this way, the importance of various netting arrangements should be paid more serious attention, and in this connection, the current framework of insolvency law may need to be reconsidered with the idea that private netting arrangements, both bilateral and multilateral, should be given validity.

2. Interdependence Among Markets

As noted above, globalization of financial markets means increased interdependence among financial markets. The experiences in Asian markets in recent years simply show this. The current debate as to whether and how to regulate "hedge funds" or "highly leveraged institutions" also suggests that any detrimental shock in one market may be transmitted to other markets. It is thus no surprise that various regulatory proposals to enhance transparency and "market integrity" are made today. While attention must be paid to the direction of the current debate on market integrity, it is also important to note that directly regulating interdependence among markets across country borders is not an easy task and may not be a wise solution to the problem.

V. Conclusion

Japan's Financial Big Bang is a drastic reform of the financial regulation. It suggests an extensive change in the Japanese legal system as well. Japan's Big Bang will probably require the increased role and function of "legal" rules. Whether the Japanese legal system as a whole will change, and more generally whether legal systems in countries experiencing a similar reform in the financial regulation will converge, are both interesting questions worth future research. But Japanese experiences suggest that financial sector reform needs fundamental reform of the country's basic legal system.

It is inevitable that Japan's Big Bang will bring the increased amount of freedom and competition in the Asia and world financial markets. Whether this will produce problems rather than benefits is not entirely clear. From a regulatory perspective, it is important to note that increased deregulation brings increased interdependence among markets and market participants. Perhaps a more direct and serious attention in financial regulation should be paid to increased interdependence among market participants. Here again, fundamental reform of the country's basic legal system, such as insolvency law, may be called for.

NOTES

<1> For the details of the loss compensation scandal, see Curtis J. Milhaupt, *Managing the Market: The Ministry of Finance and Securities Regulation in Japan*, 30 *Stanford Journal of International Law* 423 (1994).

<2> In the 10 years preceding 1989, stock prices rose sixfold.

<3> Hideki Kanda, *Globalization of Financial Markets and Financial Regulation in Japan*, *Zeitschrift für Japanisches Recht*, 1997 Number 4.

<4> The details of the Big Bang program are available in English at the web site of the Ministry of Finance <<http://www.mof.go.jp>>. See also Japan's Big

Bang, *Look Japan*, Volume 43 Number 500 (November 1997); Peter A. del Vecchio, An Overview of Japan's "Big Bang" Financial Deregulation Program, *Futures and Derivatives Law Report*, Volume 17, Number 10 (January 1998); Valentine V. Craig, Financial Deregulation in Japan, *FDIC Banking Review*, Volume 11, No. 3, at 1 (1998).

<5> These findings were based on a research project by the Asian Development Bank. See Katharina Pistor and Philip A. Wellons, *The Role of Law and Legal Institutions in Asian Economic Development 1960-1995* (1998).

<6> See, for example, Hideki Kanda, Politics, Formalism, and the Elusive Goal of Investor Protection: Regulation of Structured Investment Funds in Japan, *University of Pennsylvania Journal of International Business Law*, Volume 12, Number 4, at 569 (1991).

<7> See Gérard Hertig and Hideki Kanda, Rules, Enforcement, and Corporate Governance (draft, 1998). See also Hideki Kanda, Notes on Corporate Governance in Japan, in Klaus J. Hopt, et al. (eds.), *Comparative Corporate Governance* 891 (1998)

**The Temptation to Intervene: Problems
Created by the Government's Intervention in
the Hong Kong Stock Market**

Ms. Katherine Lynch

“THE TEMPTATION TO INTERVENE: PROBLEMS CREATED BY THE GOVERNMENT’S INTERVENTION IN THE HONG KONG STOCK MARKET”

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SYNOPSIS

The economic turmoil in Asia over the past year and a half has put the region’s financial markets under intense scrutiny, highlighting various problems, including the growing prominence of highly mobile and volatile forms of capital, extension of credit risky commercial loans by international banks, inadequate financial disclosure, lack of transparency, market manipulation, and cronyism. Hong Kong has not been immune from the impact of such economic turmoil. Following what was alleged to be a speculative move on the Hong Kong dollar (with its linked exchange rate mechanism with the US dollar) causing volatility in the financial markets in October 1997, the Government of the HKSAR undertook a review involving the Securities and Futures Commission (‘SFC’) and the Hong Kong Monetary Authority (‘HKMA’), Hong Kong’s de facto central bank. Subsequently, in August 1998, the Hong Kong stock market experienced further volatility when it is alleged that international hedge funds and investment banks (so called ‘speculators’) attacked the Hong Kong dollar and simultaneously reaped huge profits by short selling shares of Hang Seng listed shares and stock index futures. Subsequently, the HKMA intervened in the SEHK spending US\$15 billion from its foreign reserves to purchase large quantities of listed shares in an apparent attempt to thwart the alleged currency speculators for what it called unfair attacks on the Hong Kong dollar. At the same time the Government introduced a package of measures designed to ‘tighten controls on stock and futures trading’. As a result, the Government is now a major shareholder in many Hong Kong companies listed on the SEHK while at the same time, the Government through entities such as the SFC and HKMA, is also the regulator of Hong Kong’s financial markets.

This article begins by reviewing the financial turmoil in Asia and the volatility in Hong Kong’s financial markets over the last 18 months which culminated in the Government’s unprecedented intervention in the stock market in August 1998 and the introduction of various measures to tighten up the securities and futures markets. It then analyzes various problems raised by the Government’s intervention in Hong Kong’s financial markets, including the unavoidable conflicts of interests created by the Government being a major shareholder in several Hong Kong companies listed on the SEHK while at the same acting as the primary regulator of the financial markets. Problems associated with the creation of the Exchange Fund Investment Ltd. to manage the Government’s equity portfolio are also discussed. The article also examines the Government’s proposal to grant discretionary ‘emergency’ powers to the Chief Executive to direct Hong Kong’s exchanges and clearing houses and argues that giving such discretionary directive power to the head of the Government undermines the effectiveness of the regulatory authority of the SFC. Moreover, this hastily drafted measure is out of step with the international trend in stock market regulation to vest clear and objectively stated powers in an independent but publicly accountable market regulator. Any further reform measures taken by the Government must be part of a pro-active, comprehensive and rational review of the Hong Kong’s financial markets, rather than piece-meal reforms introduced as part of an ad-hoc reaction to the current financial crises. It is important to consider the recent market failures in Hong Kong in a wider perspective and not simply react with short-sighted marginal reform proposals. This is particularly important given the globalization of financial markets, increased competition from other financial markets (particularly Singapore), and the need to continue to attract foreign investment to Hong Kong.

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The University of Hong Kong, Faculty of Law
&
Asian Institute of International Financial Law

**CHALLENGES OF THE NEW INTERNATIONAL FINANCIAL ARCHITECTURE:
LESSONS FOR EAST ASIA**

June 4 – 5, 1999

**“THE TEMPTATION TO INTERVENE: PROBLEMS CREATED BY THE
GOVERNMENT’S INTERVENTION IN THE HONG KONG STOCK MARKET”**

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I INTRODUCTION

In the last thirty years the Stock Exchange of Hong Kong ('SEHK') has developed from a small local exchange into an international stock exchange currently ranking as the second largest exchange in Asia after Tokyo, in terms of market capitalization, and overall the seventh largest stock market in the world.¹ The stock market in Hong Kong did not truly function as a means of raising capital until the establishment of modern stock exchanges during the years 1969-72. In 1973 the Stock Exchange Control Ordinance was enacted which in effect limited the number of stock exchanges to four: the Hong Kong Stock Exchange (1891); Far East Stock Exchange (1969); Kam Ngan Stock Exchange (1971); and the Kowloon Stock Exchange (1973). A new era began for Hong Kong in 1986 with the unification of the four private exchanges and the establishment of the SEHK.²

The economic turmoil in Asia over the past year and a half has put the region's financial markets under intense scrutiny, highlighting various problems, including the growing prominence of highly mobile and volatile forms of capital, extension of credit risky commercial loans by international banks, inadequate financial disclosure, lack of transparency, market manipulation, and cronyism.³ Hong Kong has not been immune from the impact of such economic turmoil. Following what was alleged to be a speculative move on the Hong Kong dollar (with its linked exchange rate mechanism with the US dollar) causing volatility in the financial markets in October 1997, the Government of the Hong Kong Special Administrative Region ('SAR') undertook a review involving the Securities and Futures Commission ('SFC') and the Hong Kong Monetary Authority ('HKMA'), Hong Kong's de facto central bank. More recently, in August 1998, the Hong Kong stock market experienced further volatility when it is alleged that international hedge funds and investment banks (so called 'speculators'⁴) attacked the Hong Kong dollar and simultaneously reaped huge profits by short selling shares of Hang Seng listed shares and stock index futures.⁵ Subsequently, the HKMA intervened in the SEHK

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¹ With a market capitalization of approximately HK\$3,225 billion and listing over 660 companies. See Stock Exchange of Hong Kong, *History of the Exchange* (April 1998), Financial Secretary's Office, *Hong Kong: Center for International Business* (1997) available at: <http://www.info.gov.hk/tb/bdgt/97/leaflet/ebusin.htm> and SFC Press release, 'Chairman's Year End Remarks', 30 December 1998.

² The SEHK is a limited liability company incorporated in 1980 under the Stock Exchanges Unification Ordinance, Cap 361, although trading on the new exchange did not begin until 2 April 1986. For discussion of the historical development of the stock exchanges in Hong Kong, see Tomasz Ujejski, 'Securities Regulation', in R. Wacks (ed.) *The Law in Hong Kong 1969 - 1989* 282 and Raymond Tang, 'Establishing an Effective Legal and Regulatory Framework', 28 July 1997 available at <http://www.hksfc.org.hk/chin/speeches/rt0728-1.htm>.

³ Particularly in Indonesia, Thailand, Malaysia, and South Korea. For an insightful review of the factors leading to the Asian economic crisis - particularly the systemic changes in international capitalism and global capital flows, see Jeffrey A. Winters, 'Asia and the Magic of the Marketplace', (December 1998) *Current History* 418.

⁴ More sensationally referred to by the Financial Secretary, Sir Donald Tsang, on 14 August as the 'huge crocodiles': see Jonathan Sprague, 'Fighting "Godzillas": Post-intervention Hong Kong likely to stick with the free market', (23 October 1998) *AsiaWeek* 67.

⁵ 'Short selling' refers to the practice of borrowing stock and selling it on expectation that the price will fall before the stock has to be returned.

spending US\$15 billion from its foreign reserves to purchase large quantities of listed shares in an apparent attempt to thwart the alleged currency speculators for what it called unfair attacks on the Hong Kong dollar.⁶ At the same time the Government introduced a package of measures designed to 'tighten controls on stock and futures trading'.⁷ As a result, the Government is now a major shareholder in many Hong Kong companies listed on the SEHK while at the same time, the Government through entities such as the SFC and HKMA, is also the regulator of Hong Kong's financial markets.

This article begins by reviewing the financial turmoil in Asia and the volatility in Hong Kong's financial markets over the last 18 months which culminated in the Government's unprecedented intervention in the stock market in August 1998 and the introduction of various measures to tighten up the securities and futures markets. It then analyzes various problems raised by the Government's intervention in Hong Kong's financial markets, including the unavoidable conflicts of interests created by the Government being a major shareholder in several Hong Kong companies listed on the SEHK while at the same acting as the primary regulator of the financial markets.⁸ It also considers the Government's proposal to grant discretionary 'emergency' powers to the SAR Chief Executive to direct the exchanges and clearing houses in Hong Kong and argues that giving such discretionary directive power to the head of the Government undermines the effectiveness of the regulatory authority of the SFC. Moreover, this hastily drafted measure is out of step with the international trend in stock market regulation to vest clear and objectively stated powers in an independent but publicly accountable market regulator.⁹ Any further reform measures taken by the Government should be part of a proactive, comprehensive and rational review of Hong Kong's financial and securities markets, rather than piece-meal reforms introduced as part of an ad-hoc reaction to the current financial crises. This is particularly important given the globalization of financial markets, increased competition from other financial markets (particularly Singapore), and the need to continue to attract foreign investment to Hong Kong.

II FINANCIAL TURMOIL IN THE ASIAN REGION

The financial turmoil sweeping through Asia this past year resulted in substantial downward

⁶ Government officials allege that multi-billion dollar hedge funds first take positions betting that the stock index will fall, then they mounting attacks on the Hong Kong dollar. Since the currency is linked to the US dollar, it cannot fluctuate widely in value. Instead interest rates rise to make holding Hong Kong dollars more attractive, with the cost of borrowing raised. Stock prices fall thus rewarding the speculators' original bets. The response of the hedge funds is that they are only responding to overvalued assets and currency.

⁷ See 'Measures to Tighten Up Securities and Futures Markets' announced by the Financial Secretary Sir Donald Tsang Yam-kuen in the Legislative Council ('Leg Co') on 7 September 1998 available at <http://www.info.gov.hk/gia/general/199809/07/0907071.htm>.

⁸ This article does not comment on the Government's measures to support Hong Kong's currency peg system in August 1998.

⁹ The need for clear and objectively stated regulatory powers and for operational independence and public accountability of the market regulator is recognized in the Objectives and Principles of Securities Regulation adopted in September 1998 by the entire 150 member of the International Organization of Securities Commissions (IOSCO) (of which Hong Kong is a member). The IOSCO principles are available at <http://www.iosco.org>. See further discussion below at notes 78 and 123.

pressure on stock markets around the region, an upsurge in interest rates, rising inflation, sharply depreciated currencies and highly volatile currency exchange rate mechanisms. The regional economic turmoil started off in Thailand in the middle of 1997 when the Thai baht was substantially devalued and moved on through Malaysia, Indonesia, and the Philippines resulting in substantial depreciation of the Malaysian ringgit, Indonesian rupiah and Philippine peso. By the end of 1997, further financial troubles in Japan and widespread corporate bankruptcies in South Korea rocked North Asia. The International Monetary Fund (the 'IMF') pledged a rescue programme amounting to US\$3.9 billion to assist the Thai government, and further rescue programmes for South Korea and Indonesia amounting to US\$23 billion and US\$57 billion respectively.¹⁰ These events have had a compound effect on one another, resulting in a serious regional crisis with profound global implications.¹¹

III OCTOBER 1997: VOLATILITY IN HONG KONG'S FINANCIAL MARKETS

Hong Kong as an important international financial centre has not been immune from the financial turmoil sweeping through Asia as events over the past year and in recent months have clearly indicated.¹² In October 1997 the Government claimed that speculators launched massive short selling of the Hong Kong dollar in the expectation that the linked exchange rate with the US dollar would be broken resulting in competitive devaluation.¹³ Overnight interbank interest rates surged briefly to 280% on 23 October under the automatic mechanism of the currency board system. During that week and the following week, the securities and futures markets in Hong Kong experienced the most serious volatility in history, recording a 1,438 points (13.7%) drop in the Hang Sang Index on 28 October with a 1,705 points (18.8%) rebound on the following day.¹⁴ There were several incidents of Hong Kong financial institutions encountering financial difficulties, including the November 1997 run on the International Bank of Asia, followed by the collapse in January 1998 of the Peregrine Investment Holdings Ltd., one of the

¹⁰ With Thailand and South Korea reforming their financial regulation with IMF assistance. For a critique of the IMF rescue packages for these Asian economies, see Richard Haas and Robert Litman, 'Globalization and its Discontents', (May/June 1998), 77:3 Foreign Affairs 2. There is now extensive debate over the merit of Asian governments adopting short-term capital controls to avert a repetition of last years' financial contagion in the region. See discussion in Winters, above note 3 and 'IMF warms to forex controls', (15 September 1998) South China Morning Post.

¹¹ The Asian financial crisis has global implications and has since extended to Russia, Eastern Europe and South America. See discussion of the global financial crisis in Winters, above note 3, Haas and Litman, above note 10, Jagdish Bhagwati, 'The Capital Myth', (May/June 1998) 77:3 Foreign Affairs 7, Editorial, 'The World Economy On the Edge', (5 September 1998) The Economist 17 and Editorial, 'Global Economy, Local Mayhem', (18 January 1998) The Economist.

¹² Hong Kong slipped into a recession for the first time in 13 years with the announcement on 29 August 1998 by the Financial Secretary Sir Donald Tsang that the economy had shrunk by 5% in the second quarter (as measured by a 5% decline in the GDP or goods and services produced locally during the three months ending in June).

¹³ The HKSAR Government has not yet published any figures as to the extent of the alleged short selling of the Hong Kong dollar in October 1997.

¹⁴ The last major turmoil in the Hong Kong stock market occurred in 1987 when trading on Hong Kong's stock market was suspended for four days when the stock market crashed 43.2% as markets around the world responded negatively to Wall Street's Black Monday. At that time, the Hong Kong Government mounted a HK\$4 Billion rescue package to prevent the bankruptcy of the futures market.

largest investment firms in Hong Kong.¹⁵ This was followed by the default of CA Pacific Securities Ltd. in February and the further collapse of other local brokerage firms, including Forlux Securities and Ming Fung Group, due to fraudulent misuse and misappropriation of clients funds.¹⁶

A. Report on the Financial Market Review

In keeping with the crisis reaction pattern of regulatory reform, the Provisional Legislative Council pressured the Government for a review of the currency defence mechanism and the operation of the securities and futures markets (its most wide-ranging review of Hong Kong's financial markets since the post-crash overhaul in 1987).¹⁷ Involved in the review process were the SFC, HKMA, SEHK, Hong Kong Futures Exchange ('HKFE'), and the Hong Kong Securities Clearing Company ('HKSCC'). The review culminated with the publication on 23 April 1998 of the Report on the Financial Market Review (the 'Report')¹⁸ that was criticized as irrelevant for failing to address the issue of the linked exchange rate mechanism, focusing instead on the old familiar problems in Hong Kong's securities and futures markets.¹⁹ The Report confirmed the stability of the present monetary system without directly addressing problems related to the defence of the currency board system and inadequate disclosure by companies listed on the SEHK.²⁰ In the report, the Government affirmed (at least in print if not in practice) its commitment to maintaining and enhancing the status of Hong Kong as an international financial centre and stated as follows:

¹⁵ Peregrine Investments Holdings Ltd. was a publicly listed holding company which had 11 licensed entities providing a wide spectrum of financial services to the markets. On 21 September 1998 shareholders of the Peregrine Group launched a lawsuit against four directors of Peregrine complaining of breach of fiduciary duty by the directors and negligent misrepresentation in statements made to the media in October 1997. See 'Shareholders sue Peregrine directors', (21 September 1998) *The Hong Kong Standard*.

¹⁶ The demise of CA Pacific Securities in January 1998 affected more than 10,000 investors and exposed weaknesses in the Unified Exchange Compensation Fund ('UECF') established under the SFC Ordinance to compensate clients of brokerage firms which went bankrupt. On 28 November 1998 the Government drafted the Securities (Amendment) Bill which provides for a new three tier system compensating clients of collapsed brokerages, involving a cash fund, insurance scheme and credit facility or guarantee scheme with a maximum payout of \$150,000 per investor. See SFC Press Releases, 'SFC Welcomes Passage of Compensation Fund Arrangements', 18 November 1998, 'New Investor Compensation Arrangements', 30 September 1998 and *SFC Consultation Paper on New Investor Compensation Arrangements for Hong Kong*, 30 September 1998, all available at <http://www.hksfc.org.hk/eng/press/98>.

¹⁷ The past reviews of the regulation of the securities market in Hong Kong have all been in response to financial crises: in 1973 following the collapse of the stock market, in 1987 following Black Monday and the closure of the stock market, in October 1997 following the run on the Hong Kong dollar and more recently, in September 1998 following the Government's intervention in the stock market. See discussion in Leslie S F Young and Raymond C P Chang, *The Hong Kong Securities Industry* (1997, SEHK Ltd.) 50.

¹⁸ Hong Kong: Financial Services Bureau, Government of the Hong Kong SAR, Report on Financial Market Review, 23 April 1998, p 81. Available at <http://www.info.gov.hk/fsb/finance/index.htm>.

¹⁹ Some of the Report's recommendations included: greater financial disclosure by listed companies, review of the share repurchase code, increased transparency and access to short selling and increased sanctions for breaching the listing rules of the SEHK. See Report, pp vi - x.

²⁰ See Enoch Yiu, 'Tough controls sought in landmark review', (24 April 1998) *South China Morning Post*.

Market integrity is among the most important qualities vital to the maintenance of Hong Kong's status as a major international financial centre. Under the SFC Ordinance and other related legislation, the SFC is empowered to conduct investigations, either on its own initiative, or at the direction of the Financial Secretary, or upon public application, into suspected market malpractice including insider dealing and market manipulation. The SFC is committed to exercising its power whenever a case is demonstrated...

An important issue addressed in the Report were allegations of market manipulation, in particular, suggestions that insider dealing had occurred in connection with heavy short selling of shares of HSBC Holdings Ltd. (the parent company of the Hong Kong Bank, one of the world's largest banks) in the SEHK on 29 and 30 October 1997 prior to the announcement by Moody's Investors Service on 30 October downgrading the outlook of Hong Kong's banks and placing the ranking of HSBC and Hang Seng Bank on review for possible downgrading. It was alleged that at that time certain parties had been aware Moody's was going to release a negative report and traders had sold or shorted the shares based on that information.²¹ Although the Report concluded that the allegations of insider dealing appeared unsubstantiated,²² it recommended that the capability of the SFC and the exchanges to monitor trading and member's conduct be enhanced by strengthening their capability to obtain market information from intermediaries.²³ In addition, the Report suggested that the SFC and the SEHK revise the financial disclosure rules of the SEHK Listing Rules to improve the transparency of financial exposure of listed companies to their investors and the market.²⁴

After a year-long investigation, the SFC concluded in a formal report published on 29 October 1998 that insider dealing had not occurred in relation to the sales of shares of HSBC Holdings on 29 and 30 October 1997.²⁵ The SFC identified only three key brokerage firms who sold large quantities of HSBC shares on both days and accepted their explanations for such selling as 'logically and commercially justifiable'. Furthermore, the SFC accepted their denial of possessing any knowledge of Moody's announcement prior to the official release on 30 October

²¹ HSBC Holdings shares rebounded to HK\$188 on 29 October after dipping to a low of \$155 on 28 October following a 4% drop in the Dow Jones Industrial Average overnight. The shares dived to \$167 from \$180 after Moody's announcement of its intention to downgrade the banking group on 30 October, before gradually recovering to \$173.50. See Peter Chan, 'SFC clears trades in probe on HSBC deals', (30 October 1998) South China Morning Post.

²² At the time of publishing the Report, the SFC established that almost all of the short selling of the HSBC shares was caused by the need for Hong Kong-based entities to reduce their large exposures to the Hong Kong market and not related to Moody's announcement. See Report, above note 18, p 79.

²³ Other recommendations include linking the Central Clearing and Settlement System of the HKSCC (which handles 99.5% of SEHK transactions) with the Real Time Gross Settlement System of the HKMA (which is the monetary settlement system among banks) in May 1998; reviewing the fidelity insurance and compensation schemes of SEHK to ensure the provision of cost-effective protection of investors and market practitioners; and establishing an Investor Resources Centre in 1998. See Report, above note 18, pp ix-x and 96-7.

²⁴ The Report also recommended the introduction of measures such as application for court orders and mandatory remedies to strengthen the enforcement of compliance with SEHK Listing Rules.

²⁵ The Report of Inquiry, Dealings in HSBC Holdings Plc Shares, 29 & 30 October 1997, published on 29 October 1998 and available at <http://www.hksfc.org.hk/eng/pub/hsbc2.htm>.

1997, no doubt influenced by Moody's assertion that great care had been taken to ensure that no information was disclosed to any external third party prior to its public announcement of the downgrading.²⁶ In the Report the SFC noted that prior to Moody's announcement there had considerable speculation on the future profitability of HSBC Holdings and the level of provisions it might make for bad debts in view of the regional financial crisis.

IV AUGUST 1998: UNPRECEDENTED GOVERNMENT INTERVENTION IN HONG KONG'S FINANCIAL MARKETS

In August 1998 the Government claimed that speculative attacks were once again being mounted on the Hong Kong dollar and the fixed exchange rate to the US dollar. In an effort to take the pressure off the alleged speculation by driving down the interest rate premium on Hong Kong dollar assets, the Government responded with a massive US\$15.2 Billion (HK\$120 Billion) share purchase over a two week period beginning on August 14.²⁷ The volume of trade in the stock market surged to HK\$79 Billion with the Government estimated to have accounted for up to 90% of more than HK\$71 Billion of the massive turnover.²⁸ This intervention by the Government in the market, unprecedented in the history of the local stock market, resulted in the Government being the largest single shareholder in HSBC Holdings, the parent company of the Hong Kong Bank, with an 8.81% stake.²⁹ The official policy expressed by the Government for its intervention was 'to restore order to [Hong Kong's] financial markets...to consolidate Hong Kong's ability to manage its monetary affairs, so that we can counter manipulation of our markets...'.³⁰ Despite criticism of the Government's intrusion in the markets from economists

²⁶ Moody's stated that HSBC Holdings had only been approached 30 minutes prior to the official release of the downgrading announcement.

²⁷ After an over-night meeting on 13 August 1998 between the Chief Executive, Financial Secretary Donald Tsang, Chief Executive of the HKMA, Joseph Yam and Rafael Hui, Secretary for Financial Services, a decision was made to intervene in the market and over the next 10 days billions of dollars from Hong Kong's reserves were poured into the stock market (referred to as 'Operation Purchase'). In total the Government used up to US\$8.8 billion (about HK\$65.69 billion) of Hong Kong's US\$96.2 billion foreign reserve fund (or up to 9% of the total fund) in this share buying spree. Subsequently, on 7 September 1998 the Financial Secretary appeared before the Financial Affairs Panel of the Legislative Council ('Leg Co') to explain and defend the Government's intervention in the markets. Minutes of the meeting are available at <http://www.legco.gov.hk/yr98-99/english/panels/fa/minutes/FA70998.htm>.

²⁸ The turnover before the Government began to intervene in the market on 14 August was a mere HK\$5 Billion per day. Unfortunately, the high sovereign credit rating of Hong Kong was ultimately compromised as a result of the Government intervention in the markets, as Standard and Poor downgraded Hong Kong's credit rating from A+ to A on Sept. 2, 1998. See Enoch Yiu, 'HKMA spree tops US\$8 billion', (22 September 1998) South China Morning Post.

²⁹ Other stocks chosen for purchase by the Government include property development and utility companies such as Cheung Kong (Holdings) Ltd., Hong Kong and Shanghai Hotels, China Telecom, New World Development, Henderson Land, Sung Hung Kai Properties Ltd., and Citic Pacific Ltd (see full list of stocks purchased in Appendix A). By choosing Hang Seng Index linked stocks to purchase, it could be argued that the Government has implicitly endorsed the use of 'guanxi' or connections in Hong Kong. See Dennis Ng, 'Intervention puts millions in tycoon's pockets', (20 August 1998) The Hong Kong Standard and Editorial, 'The Temptation to Meddle', (27 August 1998) Far Eastern Economic Review 70.

³⁰ See 2nd Policy Address, 'From Adversity to Opportunity', Chief Executive Tung Chee-hwa, 7 October 1998, para 8 (the 'Policy Address') available at <http://www.info.gov.hk/gia/general/199810/07/cepa.htm>. Recent reports indicate that an investigation by the SFC of short selling activities by the local broking industry in August

and many in the financial community³¹, the Chief Executive stated in his Policy Address on 7 October 1998 that the Government's intervention in the market and its introduction of measures aimed at supporting the financial markets were not intended to '...interfere with market forces...nor broaden the powers of the Government'.³² As the economic crisis deepened in Asia, other governments around the Asian region also showed a similar willingness to actively intervene and manage their domestic economies.³³

A. Further Measures to Tighten up Securities and Futures Markets

The massive intervention by the Government in the stock market was only part of the measures taken by the Government to support Hong Kong's financial markets. On 5 September 1998 the HKMA announced a package of seven measures to strengthen Hong Kong's currency board mechanism.³⁴ Further Government proposals followed two days later on 7 September when the Financial Secretary unveiled before the Leg Co a 30-point package of measures designed to 'tighten' controls on stock and futures trading.³⁵ One important measure was to restrict the short selling of Hong Kong shares in an attempt to prevent speculators from reaping profits on trades.³⁶ It also reinforced more ruthlessly a rule that had previously been ignored – that anyone

1998 has yet to uncover any incidences of short selling that warrant prosecution. However, the Disciplinary Committee of the SEHK is investigating at least one brokerage house allegedly heavily involved in short selling in August 1998. See Enoch Yiu, 'Short-selling inquiry homes in on brokerage', (27 January 1999) South China Morning Post.

³¹ See discussion of the criticism of the Government's intervention below and footnote 60 below. See also comments made by some members of LegCo's Financial Affairs Panel on 7 September 1998 in the meeting with the Financial Secretary to discuss the Government's activities in the currency, stock and futures markets. See note 27 above.

³² See Policy Address, above note 30, para 8.

³³ Consider, for example, the recent decision by Malaysia's Prime Minister Mahathir to impose severe capital controls and halt foreign dealing in Malaysia's currency and the Japanese Government's \$500 billion rescue package for its ailing financial institutions. Even the US has not been immune from such corporate bailouts. In September 1998 Long Term Capital Management was saved from collapse by a US\$3.6 billion rescue package cobbled together by the Federal Reserve Bank of New York and a consortium of 14 US and foreign lenders. The difference with this corporate rescue, however, was that it did not involve use of any government funds. For a critique of state intervention in the Asian economies, see Editorials, 'Market Intervention Fashionable' and 'The Case for Global Finance', (5 and 12 September 1998) *The Economist* 17 and 71 and Ricardo Saludo, 'A New Course', (23 October 1998) *AsiaWeek* 58 .

³⁴ In announcing the regulations, the Financial Secretary stated that the regulations should help 'maintain a level playing field' in terms of investors' access, information disclosure and costs of holding short or long positions. See Bayani Cruz, 'Market in for Tighter Regulation', (28 August 1998) *The Hong Kong Standard*.

³⁵ For an insightful critique of the Government's measures to support the financial markets, see Professor Betty Ho, 'Comments on "Measures to Tighten Up Securities and Futures Markets" Announced by the Financial Secretary of Hong Kong on 7 September 1998', Law Working Paper Series, Paper No 22, September 1998, Faculty of Law, University of Hong Kong, p 2.

³⁶ Although this does not necessarily prevent short selling of these shares offshore, as shares of HSBC Holdings Ltd. are traded in London where they can be sold short. Similarly, shares of Hong Kong Telecom Ltd. effectively trade on the NYSE through the company's American Depository Receipts. See Eric Guyot, 'Hong Kong tightens rules on short sales of Hong Kong stock', (3 September 1998) *Asian Wall Street Journal* 1.

who sells shares short must have borrowed them first.³⁷ In addition, the HKSCC tightened rules for settling stock trades, giving brokers two days after a trade is executed to deliver the shares.³⁸ Other measures included increasing penalties for illegal short selling (increasing the maximum fine from \$10,000 to \$100,000 and jail term from 6 months to two years) and introducing legislation to make it a crime for short selling to be unreported or falsely reported to the regulatory authorities.³⁹ More controversially, the Government also proposed changing the law to grant greater powers for the Chief Executive, when public interest was under threat, to direct the SFC (the Government's market watchdog), as well as the exchanges and the clearing houses.⁴⁰ It is doubtful, however, whether there is any pressing need for the Chief Executive to have such widespread emergency powers to direct the exchanges and clearing houses, which are ostensibly private entities (see further discussion below).⁴¹

B. Creation of the Exchange Fund Investment Ltd.

For over two months from mid-August to the end of October 1998, the contents of the Government's portfolio remained unknown. Under increasing public pressure and aware of the possible conflicts of interest of owning such large and influential stakes in leading Hong Kong companies, the Government finally disclosed the amount of its shareholdings in 33 major Hong Kong companies listed on the SEHK on 26 October (see list of company shares purchased in the Appendix).⁴² The Government's intervention resulted in it owning 7.5% of the SEHK, reducing

³⁷ Sending many banks and investment funds scrambling to buy shares to cover their positions. Other measures include: probing possible illegal short selling and other misconduct in the last two weeks of August; requiring stock brokers to report all short-selling trades to market regulators; introducing penalties for brokers flouting the T+2 rule (including suspension for rule-breaking members); and the establishment of a cross-market early warning system comprising the SEHK, HKFE, SFC, HKSCC and HKMA to signals when futures activity exceeds a pre-set level on the cash market and set up response to trigger controls as needed. See critique of these measures by Professor Ho, above note 35, pp 8-10.

³⁸ Previously, the agency allowed more time to lapse and the rule, known as the 'T+2 settlement rule', will hurt speculators who entered into contracts to sell short without even having those shares on hand. The rule is opposed by more than 30 international banks, brokers and fund managers who argue that transactions across multiple time zones need to be exempted from the rule if major trading disruptions are to be avoided. See Stewart Oldfield, 'Confrontation looms on strict enforcement of T+2 deadline', (16 September 1998) South China Morning Post and Jake van der Kamp, 'Settlement exempt call on shaky ground', (3 November 1998) South China Morning Post.

³⁹ For a critique of the Government's handling of the T+2 settlement 'saga' and the imposition of criminal sanctions, see Professor Ho, above note 35, pp 21-7.

⁴⁰ At this point, it is not clear what circumstances will constitute the public being under threat to warrant the exercise of the Chief Executive's power. See discussion in Sprague, above note 4, p 68.

⁴¹ Particularly since the current legislative framework already confers a power on the Chief Executive to give such directions to the SFC in writing as regards the performance of any of its functions as he considers appropriate – and the SFC shall, in performing its functions, comply with the Chief Executive's directions. See s 11, Securities and Futures Ordinance, Cap 24 and further discussion below. See also discussion by Professor Ho, above note 35, p 19.

⁴² See Enoch Yiu, 'Intervention share buys made public', (27 October 1998) South China Morning Post.

the free float (the number of shares that may be traded on any given day) on the Hang Seng Index by about 14%, with the float on some company shares reduced by more than 25%.⁴³ The irony is that reduced such stock market liquidity may result in greater volatility - the exact opposite of what the Government hoped to achieve.⁴⁴

At the same time as disclosing its massive shareholdings, the Government announced its intention to incorporate a private limited company, the Exchange Fund Investment Ltd. ('EFIL'), to act as the private fund manager of the Government's US\$15.2 billion equity portfolio. According to Financial Services Secretary Rafael Hui, the EFIL will manage the Government's share portfolio according to guidelines issued by the HKMA and acting on the advice of the HKMA's Exchange Fund Advisory Committee.⁴⁵ The clear intention of the Government is to attempt to detach the management of its huge equity portfolio from regulators and Government administrators supervising Hong Kong's banks and financial institutions.

Subsequently, on 22 October 1998 the Financial Secretary appointed an eleven member board (the 'Board') to manage the EFIL. The EFIL Board is composed of bureaucrats, legislators, and business persons chaired by former Chief Justice Yang Ti-liang (a member of the Executive Council of the Chief Executive).⁴⁶ The appointment of former Chief Justice Yang, who has no direct experience in business or fund management, is a weak attempt by the Government to provide a degree of independence for the EFIL Board.⁴⁷ The Board includes three HKMA officials (Deputy Chief Executive Norman Chan Tak-lam and Executive Directors Marian Li Chan Sien-mun and Amy Yip Yok-tak), three legislators (Chan Kam-lam of the Democratic Alliance for the Betterment of Hong Kong, Edward Ho Sing-tin of the Liberal Party, and independent member Eric Li Ka-cheung), one financial professional (investment actuary Stuart Leckie), and one academic (Professor Tsang Shu-ki of Hong Kong Baptist University). The final two members of the Board are Financial Services Deputy Secretary Rebecca Lai Ko Wing-yee and retired solicitor, Michael Thornhill.⁴⁸ In announcing the members of the EFIL Board, the Government stated that although the EFIL will not conduct active trading of the equity portfolio, it is responsible for 'identifying value-added opportunities for the eventual disposal of the shares with minimum disruption to the

⁴³ See Chris Tinker, 'Players' attacks on intervention smack of self-interest', (7 November 1998) South China Morning Post. For a critique of this argument see Jake van der Kamp, 'Critics floating flawed argument on liquidity', (19 February 1999) South China Morning Post.

⁴⁴ For example, if the Government decides in the future to buy or sell particular shares, this could be viewed as a vote in favor or against the locally listed company, which could in turn spark huge swings in the company's listed share price.

⁴⁵ See Enoch Yiu, 'Share "guardian" move', (1 October 1998) South China Morning Post and Hoi Leung, 'Board set up to manage shares', (23 October 1998) The Hong Kong Standard.

⁴⁶ See Ray Bashford, 'Former chief justice to head shares board', (17 October 1998) South China Morning Post.

⁴⁷ It is highly questionable whether the appointment of the former Chief Justice, who lacks any real experience in fund management, can provide any guarantee of independence on the Board, particularly in view of the large number of HKMA officials on the Board.

⁴⁸ See Enoch Yiu, 'Share fund managers named', (23 October 1998) South China Morning Post.

market'.⁴⁹ In early January 1999 the SFC granted an investment adviser's licence to the EFIL which enables the company to actively manage the Government's portfolio.⁵⁰ However, the Government has stated that it intends to hold on to the shares as a long-term investment and is in no hurry to dispose of them. While the Board members will advise the Government and manage the EFIL's operations, it is understood that the Financial Secretary retains the right to veto Board decisions.⁵¹

V ANALYSIS OF THE GOVERNMENT'S INTERVENTION IN THE FINANCIAL MARKETS

In March and April of 1999 financial markets in Asia and worldwide appeared to be on stabilizing trend, although both the World Bank, the IMF and others have urged caution stating that the economic turmoil in Asia - and the associated social welfare problems - are far from over.⁵² However, the sharp rise in the Hong Kong stock market in the early months of 1999 have resulted in the Government amassing a paper gain of approximately \$88 billion on to the value of its equity portfolio since intervening in August 1998.⁵³ These gains remain theoretical, however, since the Government has not disposed of any stock purchased during its two-week buying spree last year. Any asset sale of such a large scale would undoubtedly have serious implications for the stock market in Hong Kong and risk reversing the recent stock market rally, fueled by investment from abroad (which could dry up or reverse at the first signs of trouble). With the Government holding such a significant portion of the market's free float, the manner in which the shares are eventually disposed of will be crucial. Despite the impressive paper gains made by the Government on its equity portfolio held by the EFIL, however, the intervention of the Government in the stock market last August remains troubling in a number of aspects.

In assessing the Government's intervention in the financial markets, it is ironic to note that, while the Government previously called for greater transparency and freer market mechanisms in its April 1998 Report, its present actions appeared to be moving one of Asia's

⁴⁹ See comments of Financial Services Secretary Rafael Hui reported in Hoi Leung, above note 45.

⁵⁰ See Peter Chan, 'SFC gives go-ahead for EFI to trade', (6 January 1999) South China Morning Post.

⁵¹ See Bashford, above note 46.

⁵² Despite the fact that many Asian stock markets have soared in April and May 1999, both the World Bank and the IMF believe that long-term economic recovery in Asia depends upon long term macro-economic developments (e.g. financial and corporate re-structuring, improved disclosure of financial information, curbs on risky financial borrowings etc.). See Sheel Kohli, 'Crisis far from over, Asia warned', (27 April 1999) South China Morning Post and David Saunders, 'Camdessus urges caution', (18 May 1999) South China Morning Post. Currently, there is also extensive debate about the building a new 'international financial system' to help prevent and respond to global financial crises. See for example, the remarks made by M. Camdessus, 'From the Asian Crisis to a New Global Architecture', address to the Parliamentary Assembly of the Council of Europe, Strasbourg, France, 23 June 1998 and the recent comments of US Federal Reserve Chairman Alan Greenspan in May 1999 (outlining a plan to make the global financial system less susceptible to future currency crises).

⁵³ Based on stock market levels on 20 April 1999. See Mukul Munish, '\$88b windfall for Hong Kong', (20 April 1999) The Hong Kong Standard.

most apparently laissez-faire markets in the opposite direction.⁵⁴ The intervention of the Government in the stock market to fend off alleged speculative attacks on its currency and short selling activities, as well as the proposal to grant discretionary powers to the Chief Executive to direct the stock and futures exchanges, may unfortunately restrict the transparency and certainty of Hong Kong's financial markets.

A. Criticism of the Government's Intervention – The End of the Free Market?

As the Government propped up share prices, targeted the profits of market players and established large holdings in companies listed on the SEHK last summer, Hong Kong's reputation as the global icon of laissez-faire capitalism was called into question.⁵⁵ It is arguable, of course, whether Hong Kong has ever really had a 'free' economy given the amount of Government control over the property, housing, transportation, power and (until recently) telecommunications sectors of the economy and the currency peg system.⁵⁶ Although the Financial Secretary, Sir Donald Tsang and the Chief Executive of the HKMA, Joseph Yam, argue that the intervention was essential to maintaining the stability of Hong Kong's financial markets, the Government has been criticised for its interventionist acts.⁵⁷ Some economists such as Milton Friedman argue that such intervention has substantially distorted the stock market, is totally unnecessary and counter-productive for the defence of Hong Kong's currency and jeopardises Hong Kong's status as one of the world's 'freest economy'.⁵⁸ To them it appears contrary to the laissez-faire free market policies that are the foundation of Hong Kong's economic success and standing as an international and regional financial centre.⁶⁰

Others such as noted economist Paul Krugman, however, support the intervention arguing

⁵⁴ Recall the proposals contained in the Government's April 1998 Report. For further discussion of this point, see 'Temptation to Meddle', (27 August 1998) *Far Eastern Economic Review*.

⁵⁵ On 1 December 1998 the Heritage Foundation announced that Hong Kong has lost its status as the 'freest economy' to Singapore following the Government's intervention in the stock market in August. See Heritage Foundation Press Release, 'Economic Freedom Suffers Global Setback, Survey Shows', 1 December 1998 available at <http://www.heritage.org/news/nr120198.html>. See also Stephen Seawright and Turloch Mooney, 'Hong Kong loses free-market status', (2 December 1998) *The Hong Kong Standard*.

⁵⁶ See discussion of this issue in Yash Ghai, *Hong Kong's New Constitutional Order: The Resumption of Chinese Sovereignty and the Basic Law* (Hong Kong: Hong Kong University Press, 1999, 2nd ed.) pp 27-29.

⁵⁷ See discussion of criticism of Government's interventionist activities in Sprague, above note 4, at 68.

⁵⁸ See Duncan Hughes, 'Hong Kong warned on world status', (27 August 1998) *South China Morning Post* and James Leung, 'The end of a free market', October 1998, *Asian Business*, 42 (noting that two large US investment banks, Salomon Smith Barney and Goldman Sachs, reacted negatively to the Government's intervention).

⁶⁰ Consider the criticism by Nobel Laureate economist Milton Friedman and Alan Greenspan, US Federal Reserve Chairman (arguing that the intervention was done to 'jack up' the stock market in Hong Kong and would ultimately fail and undermine the credibility of the HKMA). See review of the criticism in David Ibsen, 'Battle to sustain economic eminence', (February 1, 1999) *South China Morning Post*. In this regard, it is open to debate as to whether the Government's intervention is in conformity with Article 109 of the Basic Law which requires the Government to provide an 'appropriate economic and legal environment for the maintenance of the status of Hong Kong as an international financial centre'.

that the HKMA had no alternative but to intervene if international hedge funds were deliberately manipulating Hong Kong's financial markets.⁶¹ Others dismiss the suggestion of the destruction of the free market principle in Hong Kong as 'errant nonsense' arguing that in reality all the HKMA did was change the rules of the game – replacing short sellers of the market with genuine buyers of the stock.⁶² However, at a conference in Hong Kong in November 1998, Nobel Laureate economist Merton Miller joined currency peg architect John Greenwood in criticizing the Government's intervention in the financial markets. Both Greenwood and Miller urged the Government to immediately liquidate and dispose of its equity portfolio (by auction if necessary), even if it meant the Government had to suffer a loss as a result.⁶³

B. Illegal Manipulation of the Stock Market?

More controversial is the assertion that the Government's intervention in the market amounts to illegal manipulation of the stock market and the creation of a false market contrary to the provisions of section 135 of the Securities Ordinance.⁶⁴ It is reported that in August 1998 when the Government first intervened in the market, it initially bought futures positions ahead of its own subsequent purchases of listed shares in the equity markets, bidding up the share prices.⁶⁵ As a result, the Hang Seng Index rose upwards approximately 400 points providing the Government with 'profits' of approximately HK\$2 billion in the futures market. This activity on the part of the Government could arguably constitute market manipulation (the creation of a false or misleading appearance of active trading) under section 135 of the Securities Ordinance which provides that a 'false market' is created when the market price of

⁶¹ See Barry Porter, 'Krugman in support of intervention', (28 August 1998) South China Morning Post and discussion in Sprague, above note 5, p 68. See also Paul Krugman, 'I Know What the Hedgies Did Last Summer', Fortune, 21 December 1998 (available at <http://web.mit.edu/krugman/www>).

⁶² See Tinker, above note 43.

⁶³ See Karen Cooper, 'Intervention a blunder', (13 November 1998), Helen Johnstone, 'Greenwood urges sale of holdings', (8 November 1998) and 'Miller wipes away SAR's \$30b smile', (15 November 1998) all from South China Morning Post.

⁶⁴ Section 135, Securities Ordinance, Cap 333 provides that no person shall intentionally create or cause to be created, or do anything with the intention of creating: (a) a false or misleading appearance of active trading in any securities on the SEHK; or (b) a false market in respect of any securities on the SEHK. For the purposes of section 135(1)(b), a false market is created when the market price of those securities is raised or depressed or pegged or stabilized by means of: (a) sales and purchases transacted by persons acting in collaboration with each other for the purpose of securing a market price for those securities that is not justified either by the assets or profits of the corporation; (b) any act which has the effect of preventing or inhibiting the free negotiation of market prices for the purchase or sale of the securities; or (c) the employment of any fictitious transaction or device or any other form of deception or contrivance.

⁶⁵ It is understood that the HKMA transacted 491 August Hang Sang Index futures contracts 20 minutes before the close of trading on August 13, 1998 (representing 1.98 per cent of the turnover of 24,794 August futures contracts traded that day). See Enoch Yiu, 'Legislators say latest details given by HKMA still inadequate', (1 April 1999) South China Morning Post. Also of interest are recent reports that the SFC is investigating a broker employed by the Government during its intervention for alleged insider dealing – the broker is alleged to have used advance knowledge of the Government's trades to purchase Hang Sang Index futures contracts. See Alex Price, 'Lee urges statement on intervention misconduct', (28 March 1999) South China Morning Post.

shares is raised by means of sales and purchases transacted by persons acting in collaboration with each other for the purpose of securing a market price for those shares that is not justified either by the assets or profits of the company.

Not surprisingly, the Government vehemently rejects this suggestion and claims it has immunity from application of the Securities Ordinance by virtue of section 66 of the Interpretation and General Clauses Ordinance,⁶⁶ which provides that 'no ordinance shall in any manner whatsoever affect the right or be binding on the State unless it is therein expressly provided or unless it appears by necessary implication that the State is bound thereby.' Since there is no expressed provision to bind the State in the relevant securities ordinances, the Government argued that its operations were outside the jurisdiction of the SFC. However, section 66 expressly provides that the Government is not immune from application of ordinances, such as the Securities Ordinance, if it appears by 'necessary implication' that the Government is bound by the terms of the ordinance. The Government deliberately intervened in Hong Kong's securities and futures market with its initial purchase of futures positions and subsequent purchase of massive equity shareholdings in a large number of Hong Kong listed companies. As such, it is now a major player in Hong Kong's securities and futures markets and should be subject to the same set of regulations as other market players. If the relevant securities ordinances do not apply to the Government as an important shareholder in many listed companies in Hong Kong, then how can these ordinances effectively regulate Hong Kong's securities and futures markets and their participants? The simple answer is that they cannot. The effective operation of the securities ordinances will be severely curtailed, if not impossible, if the securities ordinances do not apply to the Government as a major participant in Hong Kong's financial markets.⁶⁷ It is imperative that the prohibition in the Securities Ordinance against illegal manipulation of the stock market should apply with equal force to the Government in its intervention in the stock market.

Certainly the intervention is contrary to the Government's previous policy of positive non-intervention – a policy which supported businesses in Hong Kong but limited interference in the financial markets.⁶⁸ The Government's decision to intervene in the stock market, however, is a clear signal that the Government desires a greater role in managing Hong Kong's economy than it has previously exercised.⁶⁹ Professor Tsang Shu-ki suggests,

⁶⁶ The Government also claimed that it was exempt from other legislation regulating the securities and futures markets in Hong Kong, such as the Securities and Futures Commission Ordinance, Cap 24, and the Securities (Disclosure of Interests) Ordinance, Cap 396 (see notes 72 and 75 below). See Enoch Yiu, 'Yam rejects accusations of creating false market through manipulation', (20 August 1998) South China Morning Post and minutes of meeting between the Financial Secretary and Leg Co's Financial Affairs Panel on 7 September 1998 (above note 28) at paragraph 30. See also note 85 below.

⁶⁷ In order to prevent defeating the plain intention of the legislature in enacting such securities ordinances to regulate Hong Kong's securities and futures markets and all its participants, such legislation should apply to the conduct of the Government as a major shareholder in several listed companies: see Robert H P Fung v First PacificBank Ltd. [1989] 2 HKLR 614.

⁶⁸ In its April 1998 Report, above note 18, the Government stated at p 4: 'We have non-interventionist policies whereby private enterprises are left to make their own business decisions, for which they are entirely accountable, and where the Government facilitates, not directs, the development of the economic sector'.

⁶⁹ Of course, the Government does not practice the policy of non-intervention in all areas as it has extensively intervened in the property market in Hong Kong - controlling the land supply and selling sites to property

however, that Hong Kong's previous policy of 'positive non-intervention' prior to the handover was really '...a policy of no commitment and no planning', that created a bubble economy dominated by property and less able to weather economic storms than the more diversified economies of Singapore and Taiwan.⁷⁰

C. The Government's Refusal to Disclose its Shareholdings

An important issue that arose immediately upon the Government's purchase of Hong Kong company shares in August is whether the Government, as a major corporate shareholder in Hong Kong listed companies, is exempt from the laws requiring public disclosure of shareholdings.⁷¹ The Government originally argued that it was not bound by such requirements,⁷² and vigorously resisted calls to publicly disclose its holdings in locally listed companies.⁷³ The SFC appeared to accept the Government's self-proclaimed contention, although the former Chairman of the SFC, Anthony Neoh, repeatedly called upon the Government to disclose the Government's stocks as soon as possible.⁷⁴ For over two months from mid-August to the end of October, the contents of the Government's portfolio remained unknown. Moreover, it was subsequently revealed that the Government purchased more than 10% of three listed companies – Swire Pacific, New World Development and Cheung Kong – but failed to disclose its shareholdings in accordance with the provisions of the Securities

development companies. In April 1999 the Government resumed land sales after a nine-month suspension in an attempt to stabilize plunging property prices. However, the willingness of the Government to actively intervene in the stock market signals a major shift in Government policy. During the October 1987 stock market crisis the Government simply took no action on the basis of its philosophy of non-intervention and that it lacked any statutory authority to intervene into a private company such as the SEHK. See discussion in Berry F C Hsu, *Laws of Banking and Finance in the Hong Kong SAR*, (Hong Kong, Open University of Hong Kong Press, 1998), p 240.

⁷⁰ See views expressed by Professor Tsang in Sprague, above note 4, p 69 and see note 130 below.

⁷¹ For example, the provisions of the Securities and Futures Commission Ordinance, Cap 24, Securities (Disclosure of Interests) Ordinance, Cap 396, the Listing Rules of the SEHK and the Code on Takeovers and Mergers require disclosure of acquisition of shareholdings equal to or exceeding 10% of the company's share capital. See above note 19.

⁷² As discussed above, the Government argued that it was not bound by the provisions of the Securities Ordinance, Securities and Futures Commission Ordinance, the Securities (Disclosure of Interests) Ordinance, nor the Code on Takeovers and Mergers based on s 66 of the Interpretation and General Clauses Ordinance, Cap 1. See above notes 66 and 67 above and Cathy Holcombe, 'HKMA "not bound" by Ordinance as analysts claim price-sensitive Information withheld' and 'Government shuns rules on disclosure', (3 September 1998) South China Morning Post. See also Professor Ho, above note 35, p 36 for further discussion.

⁷³ The Government initially refused to reveal whether it would disclose details of its shareholdings when the company was established, although it had to disclose its shareholdings in HSBC Holdings Ltd. in order to comply with the disclosure provisions of the UK law which requires disclosure for acquisitions of shareholdings above a 3% level. See Editorial, (23 October 1998) South China Morning Post, Enoch Yiu, 'Reveal stakes, urges Neoh', (30 September 1998) South China Morning Post and Bayani Cruz, 'October launch for shares minder', (1 October 1998) The Hong Kong Standard

⁷⁴ See Yiu, above note 73 and Cathy Holcombe, 'SFC scrutinises non-disclosure', (4 September 1998) South China Morning Post.

(Disclosure of Interests) Ordinance and the Code on Takeovers and Mergers.⁷⁵ As discussed above, it is difficult to see how the Government can credibly argue that it is exempt from the disclosure provisions of these ordinances and subsidiary legislation due to the ‘necessary implication’ clause in section 66 of the Interpretation and General Clauses Ordinance, Cap 1.

Such failure by the Government to disclose its substantial shareholdings is disappointing and completely inconsistent with the Government’s previous calls for and alleged commitment to greater market transparency. Recall that in its April 1998 Report, the Government stated that ‘efficient and appropriate disclosure of information and the accessibility of such information to investors are crucial elements of market transparency’. Moreover, it stressed the ‘importance of enhancing market transparency to enable investors to make their decisions based on equal and adequate knowledge about the fundamentals and prospects of the companies’.⁷⁶ It is imperative for the Government to comply, and be seen to comply, with all the relevant market regulations concerning both disclosure and dealing as required of other investors in Hong Kong.⁷⁷ Otherwise its large purchase of the public float may be perceived by market investors as conferring special status on the Government as a shareholder as compared to other private investors in the market. Furthermore, Hong Kong is one of the largest stock markets in Asia and the Government’s failure to disclose its holdings in many major Hong Kong companies created an ill-informed and uncertain market.⁷⁸

D. Conflicts of Interest Created by the Government’s Intervention

Unfortunately, the Government’s actions have created unavoidable conflicts of interest since it is now a major shareholder in many Hong Kong companies listed on the SEHK, while at the same time they are the primary regulators of the financial markets. Government policies and regulations often affect the price of shares of companies listed on the SEHK and yet the Government is now a major shareholder of many large listed Hong Kong companies.⁷⁹ Despite the Government’s efforts to downplay the conflict, the fact remains that it is both the owner of

⁷⁵ The new Chairman of the SFC, Andrew Sheng, recently confirmed that the SFC would not take action against the Government for any of its trading activities during the August intervention, arguing that the Hong Kong SAR Government was exempt from the provisions of the Securities (Disclosure of Interests) Ordinance in accordance with s 66 of the Interpretation and General Clauses Ordinance.

⁷⁶ See Report, above note 18, pp ix and 85.

⁷⁷ Moreover, the Government’s lack of disclosure and transparency are similar to some of the problems evident in the financial crisis in Asia, including inadequate financial disclosure and lack of transparency.

⁷⁸ See comments of the former SFC Chairman, Anthony Neoh, in a speech given on 29 September 1998 to the Hong Kong Institute of Directors entitled ‘Where Do We Go From Here’ at p 2 stressing the need for markets that are ‘fair, efficient, liquid and transparent’. Available at <http://www.hksfc.org.hk/eng/press/98/8pr80.htm>. It is encouraging to note that on 30 April 1999 Eric Li Ka-cheung, a director of the EFIL, affirmed that the EFIL would follow Hong Kong’s disclosure laws. See Enoch Yiu, ‘EFI appoints advisors for Government’s share sale’, 30 April 1999 (South China Morning Post).

⁷⁹ The World Trade Organization (‘WTO’) and the IMF have criticized the Government’s intervention in the stock market on this basis noting that the intervention may work to the advantage of some market participants to the detriment of others. See IMF, *World Economic Outlook: 1998* (Washington: IMF, October 1998) at pp. 7, 100 – 106 and Sheel Kohli, ‘WTO blasts Government share buys’, (9 December 1998) South China Morning Post.

Hong Kong shares and the regulator of such shares.⁸⁰ How can the Government be seen as a fair regulator of companies when it is a major shareholder in many such companies?⁸¹ The most glaring example of the conflict of interest arises from its 8.81% stake in HSBC Holdings Ltd. (the parent company of the Hong Kong Bank) which is directly supervised by a Government entity, the HKMA. Another example is the large shareholdings the Government has in several major Hong Kong property conglomerates. The Government has become the second largest shareholder of three property developers, holding 12.28% of Swire Pacific, 11.91% of New World Development and 10.34% of Cheung Kong (Holdings) Ltd. At the same time, however, the Government is the sole supplier of fresh property for real estate development that it releases to these property development companies by public auction.

A further conflict of interest arises due to the Government acting as manager of the public's investments in the stock market through the EFIL. As such, it acts in a fiduciary position in relation to the public in managing the substantial equity portfolio.⁸² The Government owes a duty to the Hong Kong public to protect the value of its equity portfolio and maximise profit on this investment. At the same time, however, the Government has a responsibility to regulate Hong Kong's financial markets to ensure Hong Kong's continuing viability as an international financial centre.⁸³ As a result, the Government has placed itself in a direct conflict of interest – its responsibilities to the public as managers of the Government's massive equity portfolio conflict with its responsibilities to adequately regulate and monitor Hong Kong's financial markets.

Related to these unavoidable conflicts of interests, is the potential for officials managing the Government's investments to deal on confidential price-sensitive information emanating from other Government departments unless effective preventive measures are taken to ensure that such information is not passed between the respective Government authorities (e.g. the establishment of 'Chinese walls').⁸⁴ Clearly the intention behind forming the EFIL was to separate Government administration from management of the Government's large equity portfolio. However, the formation of this company does not of itself solve or prevent conflicts from arising, nor does it prevent the release of confidential price-sensitive information by Government officials to managers of the EFIL. Unfortunately, the present legislative provisions governing insider dealing do not cover this problem since the definition of what constitutes confidential price-sensitive information (or 'relevant information') is restricted to specific information about a company. It does not extend to general misuse of an informational

⁸⁰ They are, in effect, both the player and the referee in the stock market game. See discussion in Mark Magnier, 'Asian governments set down rocky road with market intervention', (27 August 1998) *The Hong Kong Standard*.

⁸¹ For example, if the Government maintains a large shareholding in Hong Kong Telecom, it will have difficulty being viewed as a fair and disinterested regulator of the telecommunications industry in Hong Kong. See Chris Chapel 'Government intervention worries investors', (15 October 1998) *South China Morning Post*.

⁸² See Ewan McKendrick, *Commercial Aspects of Trusts and Fiduciary Obligations* (Oxford, Clarendon Press, 1992) at p. 9.

⁸³ Article 109, Basic Law endorses this: The Government shall provide an 'appropriate economic and legal environment for the maintenance of the status of Hong Kong as an international financial centre'.

⁸⁴ Referring to private internal rules established by organizations in order to manage conflicts of interests and prevent leaks of confidential price-sensitive information between departments within the organization.

advantage, i.e. confidential price-sensitive information relating to the economy or certain sectors of it.⁸⁵ The problem is exacerbated by the particular style of government in Hong Kong in which a large number of 'consultative bodies' drawn mainly from business interests are directly involved in the Government on daily basis.⁸⁶ As a result, there is a large number of financial 'elites' having access to valuable information – although not necessarily specific to any company - but which may be exploited for financial advantage or gain.⁸⁷ Unfortunately, the current provisions of the Securities (Insider Dealing) Ordinance do not proscribe such misuse of general informational advantage. In view of the conflicts of interests created by its intervention in the stock market, however, it is incumbent upon the Government to consider revising these legislative provisions to maintain a level playing field for investors in terms of equal access to information.⁸⁸

E. Problems with the Exchange Fund Investment Ltd.

The Government's main purpose in establishing the EFIL is to attempt to draw a dividing line between the Government's administration and management of its equity portfolio to avoid claims of conflict of interest. The EFIL will be subject to regulatory scrutiny by the SFC and should adhere to provisions of Hong Kong law concerning dealing and disclosure.⁸⁹ However, the formation of the EFIL to manage the Government's stock portfolio and the appointment of its Board members create a number of problems.

⁸⁵ See definition of 'relevant information' in relation to a corporation in s 8, Securities (Insider Dealing) Ordinance, Cap 396: '...specific information about that corporation which is not generally known to those persons who are accustomed or would be likely to deal in the listed securities of the corporation but which if it were known to them to be likely materially to affect the price of those securities'. See further discussion of this point by Professor Ho, above note 35, pp 37 - 39.

⁸⁶ See Professor Ho, above note 35, citing Norman Miners, *The Government and Politics of Hong Kong*, 5th ed (Hong Kong: Oxford University Press, 1995) p 108 onwards.

⁸⁷ In this regard, it is interesting to note the comments of Ronnie Chan Chi-chung, chairman of Hang Lung Development, and those of Li Ka-shing, chairman of Cheung Kong (Holdings) Ltd., in December 1999 complaining about the business community's diminishing influence in Government due to the rising power in political groups in Hong Kong. See David Saunders, 'Hang Lung head fears political groups will eclipse economy-driven leadership', (12 December 1998) South China Morning Post and Alejandro Reyes, 'Agony of Change', (2 April 1999) AsiaWeek 45.

⁸⁸ For example, the European Economic Community Directive Coordinating Regulations on Insider Dealing of 13 November 1989 (89/592/EE) provides that 'inside information' covers information which is likely to influence the market as a whole, e.g. information relating to the economy such as interest rates, public borrowing levels and employment figures, as well as political events. See further discussion of this point by Professor Ho, above note 35, p 38 and L. M. Ruiz, 'European Community Directive on Insider Dealing: A Model for Effective Enforcement of Prohibitions on Insider Trading in International Securities Markets', (1995) 33 Columbia Journal of Transnational Law 217.

⁸⁹ For example, the Securities Ordinance, the Securities and Futures Ordinance, Securities (Disclosure of Interests) Ordinance, and the Code for Persons Registered with the SFC (see discussion in notes 66 and 72 above). The Board of the EFIL confirmed that it will not buy or sell shares in Hong Kong until it is fully registered with the SFC as an investment advisor and securities dealer (which was approved by the SFC in early January). See Enoch Yiu, 'EFI stays in sidelines until regulator clears trading license', (16 November 1998) South China Morning Post and above note 50.

Lack of Independence of the EFIL Board

Despite Government claims that the EFIL Board is independent, the Board lacks true independence since one-third of the Board members are Government officials: three HKMA officials and the Deputy Secretary for Financial Services.⁹⁰ The EFIL will manage the Government's share portfolio according to guidelines issued by the HKMA and acting on the advice of the HKMA's Exchange Fund Advisory Committee.⁹¹ Moreover, an executive director of the HKMA, Marian Li Chan Sien-mun has been appointed Chief Executive of the EFIL and she will lead a team of 15 professional investment staff seconded from the HKMA to run the daily operations of the EFIL. Given the heavy HKMA involvement in the operations and decision-making process of the EFIL, there may be difficulty with the Board making truly independent investment decisions.⁹² In any event, investment decisions the EFIL Board makes are potentially subject to veto by the Financial Secretary.

It would have been preferable for the Government to appoint more independent financial advisors to manage its large equity portfolio. As it now stands, the only member of the Board having any direct fund management experience in the private sector is Stuart Leckie.⁹³ Two other members of the EFIL Board have fund management experience, Amy Yip Yok-tak and Marian Li Chan Sien-mun, but their independence is questionable since they are both employees of the HKMA.⁹⁴ Given the need for professional fund management of the Government's large portfolio, the appointment of more independent and experienced fund managers would enhance the credibility of the EFIL Board. It is encouraging to note that in late April 1999 EFIL director Eric Li Ka-cheung stated that the EFIL was likely to appoint 10 external fund managers to manage the Government's huge portfolio in the future, and would likely hire a small number of fund managers as internal staff to help co-ordinate EFIL operations.⁹⁵

Uncertain Investment Mandate of the EFIL

⁹⁰ The Legislator representing the financial services constituency, Fung Chi-kin, has questioned the independence of the Board given the involvement of so many government officials. Democratic Party deputy spokesman of financial affairs, Albert Ho Chun-yan, has also suggested that the EFIL will not make its own decisions but rather, will simply follow the decisions made by the Financial Secretary. See Enoch Yiu, 'Yam defends autonomy of SAR share custodian', (23 October 1998) South China Morning Post.

⁹¹ See Yiu and Hoi Leung, above note 45.

⁹² Furthermore, as Professor Ho has commented, the legitimacy of the EFIL Board is questionable given that potential dissonant voices on the Board have effectively been silenced because of the appointment of three HKMA officials and the Deputy Secretary for Financial Affairs.

⁹³ See discussion of this point in Jake van der Kamp, 'Our money managers leave us short-changed', (24 October 1998) South China Morning Post.

⁹⁴ While there is no question of the competence and professionalism of these two members of the Board, it is difficult to see how they can act independently on the Board given their employment links to the HKMA.

⁹⁵ See Enoch Yiu, 'EFI poised to take on external advice for part of portfolio', (22 April 1999) South China Morning Post.

For the first six months of the EFIL's creation, it was unclear what the precise mandate of the EFIL and its Board was and how it was to operate. The investing public was very concerned about when and how the Government's huge shareholdings would be sold back into the market, with the potential for further market volatility. The liquidity of Hong Kong's equity markets had been substantially altered by the large transfer of the 'public float' into Government ownership. Would the Government sell all its stocks over a 6-month period, or would it hold them forever as part of the Exchange Fund reserves?⁹⁶ Alternatively, would it sell all or part of the shares it had acquired back to the listed companies?⁹⁷ In October 1998 the Government stated that its intention was to hold its equity portfolio for long-term investment. It confirmed that although the EFIL would not conduct active trading of the equity portfolio, it would be responsible for 'identifying value-added opportunities for the eventual disposal of the shares with minimum disruption to the market'.⁹⁸ Despite these statements, a number of eminent economists appeared before Leg Co in November 1998 and urged the Government to immediately dispose of all shares held in its equity portfolio to minimize volatility in the market.⁹⁹

Despite repeated Government assurances that its equity portfolio would be held for long-term investment, many in the financial community pressured the Government to end the uncertainty by publicly stating its specific investment policy and strategy.¹⁰⁰ The Government responded in its March 1999 Budget Speech by announcing that it would reduce local equities held in the Exchange Fund from 17 per cent to 5 per cent of the Fund, indicating that approximately \$100 billion worth of shares would be sold (although the timetable and ways of disposal of the shares had yet to be finally determined).¹⁰¹ A long-term asset allocation strategy for the EFIL was also approved, resulting in the Fund's bond holdings cut from 90

⁹⁶ There had been rumors of institutional investors wanting to purchase the Government's large shareholdings in certain companies. Consider, for example, the rumours abounding in London and Hong Kong in the middle of October 1998 that the Government's 8.81% stake in HSBC Holdings Ltd. was facing a bid from Deutsche Bank. See Bloomberg, 'HSBC share soars on buy-in rumors' (15 October 1998) *The Hong Kong Standard*.

⁹⁷ In October 1998 there was widespread speculation that the Government would approach listed companies to buy back all or part of the shares it acquired during the August buying spree to avoid selling directly into the market and any excessive volatility resulting therefrom. See Mukul Munish and Juanito Concepcion, 'Listed firms may buy back shares', (28 October 1998) *The Hong Kong Standard* and Enoch Yiu, 'HSBC Chief says repurchasing of stock an option', (25 February 1999) *South China Morning Post*.

⁹⁸ See comments of Financial Services Secretary Rafael Hui reported in Hoi Leung, above note 45. Sir Yang Ti-liang, the Chairman of the Board of EFIL, has stated that the stock will be sold slowly and that the EFIL will 'not aim to make a profit for the portfolio. It will only buy and sell to maintain the asset value of the shareholding. It will not actively trade in the market'. See Staff Reporters, 'Government urged not to sit on boards', (27 October 1998) *South China Morning Post* and Enoch Yiu, 'EFI is urged to define policy on \$150b portfolio', (24 October 1998) *South China Morning Post*.

⁹⁹ See above note 63.

¹⁰⁰ See Johnstone, above note 63.

¹⁰¹ See HKSAR Government, *Budget Speech 1999*, 3 March 1999 at paragraphs 35 and 36 and Enoch Yiu and David Ivison, 'EFI to unload about \$100 billion of portfolio' (17 March 1999) *South China Morning Post*. At market levels as of May 1, 1999 this indicates that the Fund will sell about \$142 billion worth of shares in the near future.

per cent to 80 per cent, and equity holdings raised from 10 per cent to 20 per cent (including the 5 per cent holding in local equities).¹⁰²

Subsequently, in April the Government announced that the EFIL would form an advisory panel consisting of three international investment banks, ING Barings Asia, Jardine Fleming Securities and Goldman Sachs (Asia), which will propose the terms for disposal of the Government's large investment portfolio and then assist with executing the disposal.¹⁰³ According to EFIL Chairman Yang Ti-liang, the EFIL Board is considering a combination of the following four methods of disposing of the Government's portfolio: share placements (involving institutions acquiring large blocks of the Government's shares in local companies), unitisation (formation of unit trusts), corporate buy-backs (allowing local corporations to acquire their own shares and thus protect themselves from an unwanted take-over), and structured convertible bond issues.¹⁰⁴ Some have suggested, however, that the Government should offer its shares for sale to the public, either by directly selling a specific number of shares into the market each week, or by packaging part of its stock portfolio into a special unit trust for sale to taxpayers at a discount. Although this would likely exert downward pressure on the stock market, such direct sales would be more transparent and give everyone a chance to purchase the stocks.¹⁰⁵

Despite these developments, there is a pressing need for the Government to end the uncertainty and expressly and publicly clarify EFIL's investment guidelines, policy and strategy in order to dispel market concerns about the equity portfolio and its eventual disposal.¹⁰⁶ This is particularly true given the fact that the Government has recently merged its HK\$12 billion equity portfolio previously held by the Land Fund with the US\$15.2 billion portfolio of Hong Kong shares to be placed under the control of the EFIL. The result is that the EFIL, created to manage the shares purchased during the Government's market intervention in August, is

¹⁰² According to the Government this strategy is aimed at preserving capital, ensuring the monetary base would be at all times backed by highly liquid short term US denominated securities, and ensuring sufficient liquidity for maintaining monetary and financial stability. See Peter Chan, '\$100b portfolio sell-off', (4 March 1999) South China Morning Post.

¹⁰³ It is understood that ten international investment banks met with the EFIL Board from 4 – 7 February 1999 and submitted tender proposals, with detailed suggestions for disposal of the shares, their fees and charges, and how they would help EFIL execute the disposal. See Stewart Oldfield, 'Investment banks offer EFI ways to offload portfolio', (12 November 1998) South China Morning Post, Enoch Yiu, 'Banks tussle for seats on EFI advisory panel', (4 February 1999) South China Morning Post and Enoch Yiu and Stewart Oldfield, 'More banks considered in share disposals', (24 March 1999) South China Morning Post.

¹⁰⁴ Share placements to Mandatory Provident Fund scheme providers is also apparently an option being considered. See Enoch Yiu and David Ibison, 'EFI to unload about \$100b of portfolio', (17 March 1999) South China Morning Post.

¹⁰⁵ See Stephen Seawright, 'Templeton urges direct sales from Government's portfolio', (23 April 1999) South China Morning Post and David Evans, 'EFI urges to sell holdings to taxpayers', (29 April 1999) South China Morning Post. See also discussion above and note 52.

¹⁰⁶ More importantly, as Professor Ho has noted the Government must be consistent in its statements about its investment intentions – since August 1998 the Government's public statements about its intentions appear to have changed frequently from one week to the next. See above note 35.

rapidly becoming the Government's permanent equity portfolio manager.¹⁰⁷ In this regard the EFIL will be similar to the Singapore Government's investment company, Temasek Holdings, which has assets of \$77 billion and controls one-third of the Singapore's stock market with substantial (if not majority) shareholdings in many large Singapore companies (including Singapore Telecom, Singapore Airlines and Bank of Singapore).¹⁰⁸

At this point, it is unclear how transparent EFIL's operations will be and the degree to which its investment strategy and decisions will be publicly disclosed. Eric Li Ka-cheung, a director of the EFIL, stated in late April 1999 that the company will not announce the method and timing of the any disposal in advance and will only release EFIL results every six months. In making this announcement, Mr. Li stressed that the need to maintain market stability was more important than transparency.¹⁰⁹ Given that the massive Government intervention has complicated the risk profile of the Hong Kong stock market, however, the EFIL should make complete and timely disclosure of its shareholdings and investment decisions and strategy. Failure to make such disclosure will have a detrimental effect on Hong Kong's financial markets. It is arguable, of course, that the nature of the EFIL's business will necessarily restrict the level of disclosure of market-sensitive information since it will not want to jeopardize its own investment strategy.¹¹⁰ It is imperative, however, that after each sale from its equity portfolio, the EFIL should make full and timely public disclosure in order to maintain some level of transparency and accountability.¹¹¹ This is particularly true given that the Government itself, in its April 1998 Report, noted the need for disclosure of information accurately and efficiently to all market parties so that the financial risks associated with any investment can be detected and managed in time.¹¹²

Government Representatives on Company Board of Directors

Another troubling issue is whether the Government will seek positions on boards of the listed companies in which it bought shares. Under the rules of the SEHK any investor holding more

¹⁰⁷ See David Ibson and Enoch Yiu, 'Funds fused to fortify dollar against attack', (18 November 1998) South China Morning Post and Chan, above note 50.

¹⁰⁸ Temasek Holdings is the holding vehicle for the Singapore Government's stakes in Singapore equities and long-term holdings in government-linked companies.

¹⁰⁹ See Enoch Yiu, 'EFI appoints advisors for Government's share sale', 30 April 1999 (South China Morning Post).

¹¹⁰ See discussion of this point in Bayani Cruz, 'Officials make up majority in fund board', (24 October 1998) South China Morning Post.

¹¹¹ The EFIL may operate similar to the US Federal Open Market Committee in which information about its meetings is disclosed to the public after a sufficient time-lag. The Government, however, should avoid following the secretive practices of the Singapore Government in the operations of Temasek Holdings, its official investment arm. Temasek refuses to release any financial statements or details about its equity portfolio or operations and Temasek officials refuse to give public interviews, although Temasek is under increasing pressure to improve the transparency of its management style. See Cruz, above note 110, Editorial, 'Temasek on shopping spree', (20 November 1998) South China Morning Post and Barry Porter, 'State fund brought to heel', (15 April 1999) South China Morning Post.

¹¹² See Report, above note 18, p 78.

than 10% of the issued stock of a company has the right to a seat on the company's board of directors (the Government holds more than 10% shareholdings in Swire Pacific, New World Development and Cheung Kong).¹¹³ If the Government's appoints representatives to these companies' boards, however, they may be in a conflict of interest position. These Government representatives may have knowledge of relevant confidential Government policy (e.g. concerning land development) and yet at the same time, they will be involved in formulating the companies' actions, decisions and strategies as members of the board of directors. It is understood that Swire Pacific and New World Development have expressed serious reservations about Government representatives assuming seats on their boards due to potential conflicts of interests.¹¹⁴ In March 1999 the EFIL confirmed that it will advise the Government not to place representatives on company boards and that it will not vote on routine corporate affairs that have no material impact on the Government's shareholdings (e.g. declaration of dividends or appointment of auditors).¹¹⁵ However the Government has reserved the right to send representatives to the boards of listed companies to 'safeguard its shareholdings as they were bought with tax-payers' money'.¹¹⁶

The Need for Transparency in Government Financial Institutions

The final troubling issue is that the creation of the EFIL and the management of the Government's huge equity portfolio primarily by HKMA officials, is a challenge to the development of constitutionalism in Hong Kong and the need for fair, transparent and accountable government institutions.¹¹⁷ The EFIL will likely be around for a long time to come, particularly now that it has been given the mandate to manage the Government's HK\$12 billion equity portfolio previously held by Land Fund. Given the Government's institutional choice and commitment to establishing the EFIL, it will be extremely difficult for the Government to backtrack and dismantle the EFIL.¹¹⁸ The creation and operation of this new state financial institution in Hong Kong, however, undermines both the operation of Hong Kong's financial markets and the fair and open system of financial governance in Hong Kong.¹¹⁹ Moreover, it is

¹¹³ See Staff Reporters, 'Government urged not to sit on boards', (27 October 1998) South China Morning Post.

¹¹⁴ See Mukul Minish, 'Firms buck SAR board seat plans', (30 October 1998) The Hong Kong Standard.

¹¹⁵ See Yiu and Ibison, above note 104.

¹¹⁶ See David Saunders, 'Tsang confirms no board seats following \$118b investment', (31 October 1998) South China Morning Post and Stephen Seawright and Mukul Munish, 'Government won't seek seats on firms' boards, says Tsang', (31 October 1998) The Hong Kong Standard.

¹¹⁷ Professor Davis suggests that the fundamentals of 'constitutionalism' include three core institutional components: democratic elections with free and fair multiparty contestation; human rights and freedom of expression; and the rule of law, including adherence to principles of legality. See Michael C. Davis, 'Constitutionalism and East Asian Economic Development', (December 1998, on file with author) p 3.

¹¹⁸ See Davis, above note 117, p 19 (discussing the links between economic reform and democracy and the institutions of constitutional government).

¹¹⁹ The introduction of EFIL as a new institutional actor has fundamentally changed the operation of Hong Kong's financial sector. This is illustrated by recent reports that officials of Shanghai Industrial Holdings, in which the Government holds an 8.49 % stake, consulted with some board members of the EFIL (on an informal basis) before deciding to amend the company's hotel purchase plan. See Enoch Yiu, 'EFIL consulted over cancelled purchase', (15 December 1998) South China Morning Post.

the exact opposite of the Chief Executive's rhetoric in his October 1998 Policy Address stressing his commitment to transparency and accountability in the governance of Hong Kong.

F. Proposal to Grant Discretionary 'Emergency' Powers to the Chief Executive

Of questionable merit is the proposal to grant greater powers for the Chief Executive, when public interest was under threat, to direct the SFC, as well as the exchanges and the clearing houses.¹²⁰ Despite the Government's earlier commitment to strengthen the supervisory capacity of the SFC, this proposal subordinates the SFC to the supervision of the Financial Services Bureau and indicates a breakdown in relations between the Government and the SFC. Granting such discretionary directive power to the appointed head of the Government (even if only in a public emergency) undermines the effectiveness of the regulatory authority of the SFC and is a challenge to the legitimacy of the SFC as an independent authority regulating Hong Kong's financial markets.¹²¹ Moreover, it is completely out of step with the international trend in stock market regulation to vest clear and objectively stated powers of market regulation on an operationally independent but publicly accountable market regulator.¹²² IOSCO's Objectives and Principles of Securities Regulation adopted in September 1998, which represent the most comprehensive set of international standards for securities regulation, explicitly recognize the need for clear and objectively stated regulatory powers and for operational independence and public accountability of the market regulator.¹²³ Despite the Government's publicly stated intention to reform and upgrade Hong Kong's regulatory framework to international standards in order to maintain and protect the integrity of Hong Kong's financial markets, this proposal falls short of any such international standards by removing the independence and public accountability of market regulators.

Although the full ramifications of this hastily drafted proposal have clearly not been considered, the Government appears to be pressing ahead with its implementation.¹²⁴ The result will be that the Chief Executive, the appointed political head of the Government, can effectively dictate trading rules that must be implemented by the SEHK, HKFE and HKSCC. The legitimacy of the proposal is questionable since there are few, if any, apparent limits on the Chief Executive's exercise of such discretionary powers. Although the Chief Executive claimed in his October 1998 Policy Address that it is not the intention of the Government to expand the powers of the Government, that is precisely the result of granting such discretionary emergency powers

¹²⁰ At this point, it is not clear what circumstances will constitute the public being under threat to warrant the exercise of the Chief Executive's power. See discussion in Sprague, above note 4, p 68.

¹²¹ The SFC has argued against this proposal on the basis that: (a) the Chief Executive already possesses sufficient powers to give directions to the SFC in writing as regards the performance of its functions under s. 11, Securities and Futures Ordinance; (b) the proposal will undermine the regulatory authority of the SFC; and (c) the proposal will undermine the autonomy of Hong Kong's securities and futures markets.

¹²² See comments in this regard by Anthony Neoh (former Chairman of the SFC), above note 73, at p 5.

¹²³ Hong Kong is a member of IOSCO: see above note 9.

¹²⁴ See Enoch Yiu, 'Government snubs SFC over wider Chief Executive powers in the markets', (19 February 1999) South China Morning Post.

to the Chief Executive.¹²⁵ Are Hong Kong's financial difficulties to be used as an excuse for increasing the authoritarian practices of the Government and the potential for administrative arbitrariness concerning Hong Kong's financial policies?¹²⁶

While the answer to this question remains to be seen, the proposal is clearly contrary to the Government's stated policy of not directing - but merely 'facilitating' - the development of Hong Kong's financial markets.¹²⁷ The Government's statements emphasising the need for 'stability' in Hong Kong's financial markets may be interpreted as the Government's desire for greater 'control' over Hong Kong's economy (in particular, direct control over the stock and futures markets). Unfortunately, vesting the Chief Executive with broad discretionary power to direct Hong Kong's financial markets (with few limitations on the exercise of such power) is in keeping with Chief Executive Tung Chee-hwa's paternalistic style of governance and lack of policy consultation to date.¹²⁸ In this sense, the proposal to broaden the Chief Executive's powers to direct Hong Kong's financial markets has a fundamental constitutive status.¹²⁹ The proposal is an unfortunate move towards an authoritarian orientation rather than a democratic orientation in financial policy-making within Hong Kong. Ultimately, the Chief Executive may be able to issue policy directives impacting upon Hong Kong's economic and financial laws in Hong Kong - in other words, law may become subservient to policy decisions made by the Chief Executive.¹³⁰ The proposal is troublesome because it increases the propensity of the Chief Executive to govern by what Roberto Unger characterizes as the 'commands of the sovereign' under a bureaucratic or regulatory legal system rather than a legal system associated with the rule of law ideal.¹³¹ The effective result of the proposal is a

¹²⁵ See above note 30, para 8.

¹²⁶ In this regard, consider the comments of Professor Michael Davis concerning the impact of the Asian financial crisis on authoritarian development models in Asia - is the crisis evidence of the failure of authoritarian developmentalism or an excuse for persisting in authoritarian practices? See Davis, above note 117, in which he argues that the current financial crisis points to the need for liberal constitutional reform.

¹²⁷ See statements of the Government in April 1998 Report, above note 18. Under this proposal, there is potential for considerable Government interference with Hong Kong's financial markets which may increase investor anxiety in the future.

¹²⁸ See further discussion below.

¹²⁹ Another example of financial and monetary policies taking on a fundamental constitutive status is the decision of the Malaysian Prime Minister Mahathir to impose severe foreign exchange controls. If these measures persist for a long time, they will dramatically change Malaysia's economic structure. See discussion of this point by Professor Davis, above note 117, p 26.

¹³⁰ Since under Article 45 of the Basic Law the Chief Executive is appointed by the Central People's Government of the PRC (the 'CPG'), what prevents the CPG from pressurising the Chief Executive to greater and greater state intervention in Hong Kong's economy? See general discussion of this issue in Stanley Lubman, 'Chinese Administrative Law and the Challenges of Chinese Law Reform', (on file with author, 1 December 1998) p 22 - 24.

¹³¹ See Roberto Unger, *Law in Modern Society* (New York, Free Press, 1976). The proposal accords with more with 'state-allocative laws' (as distinct from 'market-allocative laws') which represent a legal regime specially created by the state and conferring significant power on the state to regulate the economy. See discussion of state-allocative laws in the *Report of the Asian Development Bank on the Role of Law and Legal Institutions in Asian Economic Development 1960 - 1995* (1998).

move away from a rule-based legal system to a more bureaucratic system of governance marked by the exercise of discretionary powers with few effective constraints.¹³²

One of the most important aspects of economic growth for any economy is financial stability, and the foundation for such financial stability is based on the underlying legal and financial infrastructure. A lack of rule- or law-based financial sector reform in Hong Kong will only hamper its ability to deal with the long term implications of the recent financial crises and ultimately, thwart the development of a healthy and robust economy.¹³³ The proposal granting the Chief Executive broad discretionary powers to direct Hong Kong's securities and futures markets has the potential to seriously undermine the central importance of the rule of law as a necessary condition for Hong Kong's long term economic growth.¹³⁴

VI CONCLUSION

The final economic analysis of the merits of the Government's intervention in Hong Kong's financial markets – was it a shrewd investment or a reckless gamble – remains to be seen.¹³⁵ Irrespective of whether the intervention proves to be good or bad news for the stock market, however, it has created a number of problems that will have a long lasting impact on Hong Kong's financial markets generally and on Hong Kong's role as an international financial centre. Despite the Government's attempts to minimise the conflicts of interest created by its intervention in the markets, the fact remains that it is both a major shareholder in many listed Hong Kong companies, and at the same time, it is the regulator of Hong Kong's financial markets. Moreover, the conflicts of interest have not been remedied by the formation of the EFIL to manage the Government's substantial equity portfolio, particularly given the heavy involvement of the HKMA in the administration and operation of the EFIL. The ability of the EFIL to make investment decisions independent of some degree of Government influence is questionable.

Notwithstanding the problems inherent with the EFIL, a more difficult issue the Government

¹³² Rule-based legal procedures correspond to the notions of due process of law and effective legal limitations on the arbitrary exercise of state power. By contrast, discretionary procedures refer to the unfettered discretion which the executive can exercise in pursuit of its policies and objectives. See discussion in Albert Chen, 'Law and Development: A Commentary on the Asian Development Bank's Report on the Rule of Law and Legal Institutions in Asian Economic Development 1960 – 1995' (December 1998, on file with author) pp 3 – 4.

¹³³ This idea has been formally recognized in the Report of the Group of Ten (G-10) Working Party on Financial Stability in Emerging Markets, *Financial Stability in Emerging Market Economies: A Strategy for the Formulation, Adoption and Implementation of Sound Principles and Practices to Strengthen Financial Systems* (April 1997) (available at <http://www.bis.org>). See detailed discussion of this issue in J. Norton, 'Financial Sector Reform and International Financial Crises: The Legal Challenges', (1998) 16 *Essays in International Financial & Economic Law* 5, Douglass North at note 133 above and the *Report of the Asian Development Bank*, above note 131.

¹³⁴ Douglass North and his theory of new institutional economics emphasises the importance of the institutional environment for economic growth and the need for the rule of law (referring generally to security of property rights and effective contract enforcement) as a necessary condition for a state's long term economic development. See Douglass North, *Institutions, Institutional Change and Economic Performance* (Cambridge, Cambridge University Press, 1990) and discussion in Chen, above note 132 at pp 9 – 10.

¹³⁵ See note 52 above.

will have to deal with is damage resulting to the administration's credibility and authority to govern. The Government's handling of the financial crisis and its intervention in the stock market has been a blow to the confidence of the investing public (both domestically and internationally) in the financial regulators and the Government.¹³⁶ The intervention has raised suspicion that, if the Government can abandon its long-standing free market policy in the financial markets, it may do so in other areas.¹³⁷ More importantly, the crisis has called into question the style of governance of the Chief Executive Tung Chee-hwa.¹³⁸ Neither the Executive Council nor Leg Co was consulted by the Chief Executive or the Financial Secretary about the decision to launch Operation Purchase in August – one of the biggest policy decisions in years.¹³⁹ Furthermore, the crisis has injected further tension into the already strained relationship between the Chief Executive and Hong Kong's partially elected Leg Co. Since the hand-over, the Chief Executive has only visited Leg Co on limited occasions and has held very few policy consultations with legislators.¹⁴⁰ Certainly there was no consultation with Leg Co prior to the launch of Operation Purchase in August.¹⁴¹ Members of Leg Co have openly criticised the Chief Executive for lacking vision and long term strategy for Hong Kong and recently refused to give the Chief Executive the customary vote of thanks after his second annual Policy address.¹⁴²

¹³⁶ See James Leung, 'The End of a Free Market', October 1998, *Asian Business*, p 42. A report by a private consulting group, Political and Economic Risk Consulting, in August 1998 indicated that public confidence in the Hong Kong SAR Government has been eroded due to inept handling of the economic crisis and other domestic issues such as the clumsy handling of the Chinese language education, the avian flu scare and the bungled opening of the new airport in July 1998. See David Saunders, 'Public confidence eroded survey finds', (20 August 1998) *South China Morning Post*.

¹³⁷ For example, Martin Lee, leader of the opposition Democratic party, questioned the Financial Secretary at the 7 September session of Leg Co as to why the Government failed to act earlier in the economic crisis and the real reason behind the Government's intervention. See Hoi Leung, above note 45.

¹³⁸ Popular opinion views the Chief Executive as increasingly out of touch with the people of Hong Kong and less accountable and more patriarchal in style of governance. See Editorial, (28 November 1998) *The Economist* 25 (noting the lack of policy discussion and debate between the Chief Executive and the civil service led by Anson Chan) and Professor Ho, above note 35, p 37.

¹³⁹ Operation Purchase was presented to Leg Co as a 'done deal'. In fact, nearly all of the Government's major initiatives have been adopted with minimal consultation. The recent economic crisis has also focused the public's attention on the competence and quality of Hong Kong's civil service to govern the SAR. See Sin-Ming Shaw, 'The Leadership Gap', (12 October 1998) *Newsweek* 29 (noting that Hong Kong's civil service failed to measure up in terms of education and training when compared to the civil service in Singapore and Taiwan).

¹⁴⁰ See Alkman Granitsas, 'Hong Kong: Silent Treatment' (12 November 1998) *Far Eastern Economic Review* 21.

¹⁴¹ Arguably Leg Co should have been briefed more thoroughly in the event of another 'attack' by speculators and the potential need to further appropriate more public funds. See comments of legislators in this regard to the Financial Secretary at the meeting of Leg Co's Financial Affairs Panel on 7 September 1998 (above note 27 at paragraphs 26 – 29).

¹⁴² The only other time this was done was in relation to one of former Governor Patten's Policy Addresses. Public reaction to the Chief Executive's policy address was generally negative asserting that it failed to offer solutions to the problems facing Hong Kong. See Chris Yeung, 'Tung fails to offer solutions', (8 October 1998) *South China Morning Post*.

It is imperative that the relationship between the appointed Chief Executive and the independent market regulator – the SFC – be reviewed in light of the proposal to grant the Chief Executive powers to direct the exchanges in Hong Kong. The long term ramifications of giving such discretionary powers to the Chief Executive, the political head of Government, merit further review and reconsideration. If the Government truly wants to consolidate Hong Kong's ability to manage its financial affairs (as it claims), it must undertake a comprehensive review of the function and powers of the HKMA, SFC, SEHK, HKFE and HKSCC and their relationship with a view to enhanced co-ordination between these regulatory bodies.¹⁴³ The Government's intervention in the stock and futures markets last August indicates how closely related the activities of these bodies have become but how poorly co-ordinated their regulation is.¹⁴⁴ Although there has been discussion of co-ordination by a 'super-regulator' modelled after the UK's Financial Services Authority which supervises the entire financial services sector in the UK, this appears to have been unfortunately vetoed by the new SFC Chairman.¹⁴⁵ To substantiate the rhetoric of Chief Executive in his October 1998 Policy Address (and that of Sir Donald Tsang, Financial Secretary and Joseph Yam, Chief Executive of the HKMA), it is imperative that the Government take clear and decisive action to improve the co-ordination between these regulatory bodies and the regulatory framework of Hong Kong's financial markets generally.

This is particularly important since the Government has recently announced a series of reform measures aimed at improving the management and transparency of Hong Kong's financial markets. In its March 1999 Budget Speech, the Government announced that the SEHK and the HKFE and their associated clearing houses should be de-mutualized and merged together to form a holding company that would thereafter list on the new merged exchange by September 2000.¹⁴⁶ To proceed with the controversial merger proposal, 75 per cent of the 500 stockbrokers and 130 futures brokers will have to vote in favor of the reforms at meetings to be held in August 1999.¹⁴⁷ These reform proposals have led to debate concerning the division

¹⁴³ See discussion of this point by Professor Ho, above note 35, pp 18 - 19.

¹⁴⁴ See discussion in Helen Johnstone, 'SAR fails to grasp post-crisis regulatory nettle', (21 March 1999) South China Morning Post.

¹⁴⁵ See comments by SEHK Chairman Lee Hon-chiu in Hoi Leung, 'Super financial watchdog on way' (31 October 1998) The Hong Kong Standard and Johnstone, above note 144.

¹⁴⁶ The de-mutualization of the stock exchange follows global trends and will separate ownership and trading rights within the exchange, allowing the management of the new enlarged exchange to operate as a profit-making organization. The de-mutualization proposal is modeled after the Australian Stock Exchange ('ASX'), which carried out a de-mutualization plan in 1997 and was changed from a company owned by its members to a publicly traded body whose shares were listed in its own markets in October 1997. The ASX recently announced its intention to takeover the Sydney Futures Exchange making it the largest dual-market in the Asia-Pacific region. See Enoch Yiu, 'Ex-SFC Chief says changes help lift ASX', (1 May 1999) South China Morning Post.

¹⁴⁷ The merger may end allegations made by former SFC Chairman Anthony Neoh that the SEHK is run like a "private club for its members". However, the merger proposal has met with opposition from some brokers who are concerned about issues such as the pricing of the re-structuring of the exchanges, e.g. how the value of the membership in the merged stock and futures exchange will be calculated. See Enoch Yiu, 'Budget predicted to merge exchanges', (27 February 1999) South China Morning Post.

of regulatory authority between the SFC and the SEHK over the brokerage industry and listed companies. The Hong Kong Stockbrokers Association is understood to want the new enlarged exchange to remain as regulator for brokers and listed companies, while the Government wants the SFC to adopt more regulatory powers from the exchange, given that the new exchange will be a profit-oriented company.¹⁴⁸ The Government has established a Steering Committee on the Enhancement of Financial Infrastructure in Hong Kong which will consider ways of improving trading, settlement and risk management in the securities and futures markets, review the SFC's regulatory powers (particularly with respect to derivative products and internet trading), and help facilitate the proposed merger of the exchanges.

Hong Kong is facing stiff competition from other international markets, with Singapore revamping its regulatory system to challenge Hong Kong as a leading international financial centre in Asia.¹⁴⁹ Several forces are fuelling this regulatory competition,¹⁵⁰ including the globalization and de-regulation of financial markets, advances in electronic technology (the development of internet trading), and consolidation in the securities industry generally. As a result, there is a need for the application in Hong Kong of common international standards regulating securities and futures markets world-wide (such as those established by IOSCO).¹⁵¹ Hong Kong must reform its patchwork securities legislative framework into a single coherent set of securities legislation in keeping with international regulatory standards. It is encouraging to note the comments of the SFC Chairman in December 1998 regarding plans to introduce 'radical reforms' in Hong Kong in 1999 to bring Hong Kong into line with international standards and enhance its ability to compete.¹⁵² It is important, however, that

¹⁴⁸ See Enoch Yiu, 'Rift growing over broking sector control', (3 May 1999) South China Morning Post.

¹⁴⁹ In 1996 Singapore announced it would liberalize its international and domestic market from April 2000 onward. More recently in November 1998 Singapore unveiled measures to make itself more economically competitive, including the merger of its stocks and futures exchanges and the launch by Singapore International Monetary Authority of a rival Hong Kong index futures product with data supplied by Morgan Stanley Capital International. For discussion of this issue, see Cesar Bacani, 'Who Has the Edge? Hong Kong Versus Singapore', (27 November 1998) AsiaWeek 60 and David Ibson, 'Battle to Sustain Economic Eminence', (21 February 1999) South China Morning Post.

¹⁵⁰ Often referred to as 'regulatory arbitrage' meaning that parties make their investment decisions based on the regulatory regime most favorable to them. This often results in one market lowering regulatory standards to attract investors from other markets. See David Charney, 'Competition Among Jurisdictions in Formulating Corporate Law Rules: An American Perspective on the "Race to the Bottom" in the European Communities', (1991) 32 *Harvard International Law Journal* 423.

¹⁵¹ Other international organizations, including the Organization for Economic Cooperation and Development ('OECD'), Bank of International Settlement, the International Association of Insurance Supervisors, and the International Accounting Standards Committee, have also been working to establish common understanding and standards for the world's financial markets. See notes 9 and 78 above.

¹⁵² See Andrew Sheng, 'Chairman's Year-end Remarks', 30 December 1998, available at <http://www.hksfc.org.hk/eng/press/98/8pr120.htm> and Enoch Yiu, 'SFC in push for radical reforms', (December 31, 1998) South China Morning Post. In May 1999 the Chairman of the SFC stated that Hong Kong should follow international trends and adopt the US-disclosure based regulation model for securities markets. It has also been suggested that the SFC's role should be transformed from that of "police" of the local securities market to more of a "referee" and "mentor" role, with an independent review committee established to review SFC investigations (similar to the Operation Review Committee which examines ICAC investigations). See Enoch Yiu, 'Exchange urges SFC to take tougher stand' and 'SFC looks at review panel as check on wider powers', (29

the reform process undertaken by the Government and the SFC be broadened and further enhanced with the enactment of a revised Composite Securities and Futures Bill giving the SFC broad regulatory powers over all institutions engaged in Hong Kong's securities industry (including banks).¹⁵³

Rather than the current piece-meal reforms introduced as part of an ad-hoc reaction to the recent financial crises, reform of Hong Kong's securities and futures markets should be part of a pro-active, rational and comprehensive process.¹⁵⁴ It is important to consider the recent market failures in Hong Kong in a wider perspective and not simply react immediately with short-sighted marginal reform proposals. The recent financial crises provide a good opportunity for an independent and comprehensive review of Hong Kong's financial systems and the sufficiency of its regulatory environment. Central to this reform process should be the desire to maintain the integrity of Hong Kong's financial markets and the investing public's confidence in those markets.

April 1999) and (1 May 1999), South China Morning Post.

¹⁵³ The proposed Composite Securities and Futures Bill has been in preparation since the early 1990's, but has yet to be tabled before Leg Co due to heated debate over its contents (e.g. whether the SFC should have regulatory authority over the electronic trading system). While it is understood that Leg Co has allocated a slot for consideration of this Bill in 1999, further reform of the Bill is urgently needed to improve the regulatory framework for Hong Kong's financial markets. See *SFC Consultation Paper on a Draft for a Composite Securities and Futures Bill*, June 1997 (available at <http://www.hksfc.org.hk/eng/consult/bill.htm>) and *SFC Guidance Note on Internet Regulation* (31 March 1999) (available at <http://www.hksfc.org>).

¹⁵⁴ At the same time, there must be reform in the corporate governance of locally listed companies (e.g. improved transparency and disclosure) if Hong Kong is to be the pre-eminent capital market in Asia. See the work of the OECD in identifying some fundamental parameters of corporate governance and the International Corporate Governance Network in developing 'global principles of corporate governance'. For further discussion, see R. Tomasic, and G. Nicoll, 'Global Framework for Good Governance' and A. Tsui, 'Governance Issues for the SAR from the Stock Exchange Perspective', both in (1999) 2:2 *Corporate Governance International* 81 and 134 respectively.

VII. APPENDIX

THE HONG KONG SAR GOVERNMENT'S EQUITY PORTFOLIO

Name of Company	Percentage of Companies Held
Swire Pacific	12.28
New World Development	11.91
Cheung Kong (Holdings) Ltd.	10.34
HSBC Holdings Ltd.	8.81
China Resources Enterprises	8.78
TVB	8.56
Shanghai Industrial Holdings	8.49
Hong Kong Telecom	8.16
Sun Hung Kai Properties	8.01
Hutchison Whampoa	7.86
CITIC Pacific	6.9
Hong Kong & China Gas	6.67
Guangdong Investments	6.33
Hong Kong Electric	6.15
Bank of East Asia	6.1
First Pacific	6.07
Hysan Development Co.	5.89
Hang Seng Bank	5.71
CLP Holdings	5.5
Wharf Holdings	5.3
Hong Kong & Shanghai Hotel	4.97
Henderson Land	4.96
Hopewell Holdings	4.78
Great Eagle	4.51
Cheung Kong Infrastructure	4.28
China Telecom (HK)	4.06
Cathay Pacific	3.52
Shangri-La Hotels	3.44
Sino Land	3.43
Henderson Investments	3.24
Wheelock & Co	3.08
Hang Lung Developments	2.5
Amoy Properties	2.49

Source: 27 October 1998, South China Morning Post citing Exchange Fund Investment and Bloombergs

**Importance of Financial Services Sector
Reform for Foreign Financial Institutions in
Japan and the PRC**

Dr. Brian Semkow

PRC

Foreign banks

- PRC, Administration of Foreign Investment Financial Institutions Regulations, (FIFI Regulations), State Council, February 25, 1994 and April 1, 1994; and, Administration of Foreign Investment Financial Institutions Regulations Implementing Rules (FIFI Implementing Rules), PBOC, May 8, 1996
- foreign banks in Shanghai were permitted to conduct renminbi business on restricted basis:
- Shanghai Pudong New Zone, Administration of Pilot Operation of Renminbi Business by Foreign Investment Financial Institutions Tentative Procedures, PBOC, December 22, 1996
- Shenzhen Economic Zone, Guidelines Concerning the Trial Operation of Renminbi Business by Foreign Invested Financial Institutions, PBOC Shenzhen branch, August 13, 1998
- renminbi licenses include participation on interbank market
- PRC, Commercial Banking Law, July 1, 1995

Foreign insurance companies

- Provisional Measures on the Administration of Foreign-Invested Insurance Institutions in Shanghai, PBOC and MoF, September 11, 1992, jvs and branches
- Guangzhou Measures
- PRC, Insurance Law, June 30, 1995 (IL, under article 148, applies to foreign insurance companies as they do business through branches or jvs)
- insurance agents, Administration of Insurance Agents Tentative Provisions, November 30, 1997, PBOC
- insurance brokers, Administration of Insurance Brokerage Provisions (Trial Implementation), PBOC, February 16, 1998

Foreign securities firms

- Administration of Representative Offices in China of Foreign Financial Institutions Procedures, PBOC, April 29, 1996
- Administration of Qualification of Domestic and Foreign Securities Trading Institutions for Engagement in Foreign Investment Shares Business Tentative Provisions (Foreign Investment Share Provisions) (B-Share Regulations for Foreign Securities Companies), CSRC, November 15, 1996, December 1, 1996.
- China International Capital Corporation (CICC), first Sino-foreign investment banks, which began operations in August 1995

Foreign finance companies

- FIFI Regulations, 1994 and FIFI Implementing Rules, , PBOC, May 8, 1996
- PBOC Circular on the Relevant Issues Concerning the Establishment and Operation and of the Foreign Investment Enterprise Group Family, October 28, 1996, and the Administration of Finance Companies of Enterprise Groups Tentative Procedures, September 27, 1996.

Foreign financial leasing companies

- Circular Concerning Approval of the Establishment of Sino-Foreign Leasing Companies, 1985, MOFTEC

Foreign Mutual Funds

- Administration of Securities Investment Funds Tentative Procedures, State Council, November 14, 1997
- Drafting of Sino-Foreign JV Fund Regulations, announced CSRC, April 1998

Foreign representative offices

- PBOC, Procedures for the Administration of Representative Offices of Foreign Financial Institutions in China, April 29, 1996. (Repealed the PBOC, Administration of the Establishment of Resident Representative Offices in China by Financial Institutions with Foreign Capital Procedures, June 1, 1991

WTO Accession

JAPAN

Foreign banks

- Bank Law 1981
- Financial Accord, 1984
 - Foreign trust banks, 1985
 - Banks with securities operations, 1985
- Big Bang Financial Reform, 1998
- Financial Restructuring Commission, LTCB and NCB
- Citibank and retail banking

Foreign securities firms

- Law Concerning Foreign Securities Dealers, 1971
- Financial Accord, 1984 and TSE entry
- Financial Services Accord, US-Japan, 1995
- Big Bang Securities Reform, 1998-99
 - Branching
 - Investor Protection Fund
- Merrill Lynch and retail brokerage
- Citigroup and Nikko Securities
- TSE foreign members with 80 per cent of pre-tax profits in FY 1998

Foreign insurance companies

- Law Concerning Foreign Insurers, 1949
- Insurance Business Law 1995, subsumes LCFI
- Big Bang Insurance Reform, 1998
 - rating organizations
 - mutual entry acceleration
 - holding company system
 - distribution of insurance products
 - 'mark to market' valuations of insurance company portfolios
- Insurance Measures, US-Japan, 1994
- Supplementary Measures, US-Japan, 1996

- GE-Capital Toho
- Manulife-Daihyaku Mutual Life Insurance Company

Foreign mutual funds companies

- Guidelines 1989 and 1992 and foreign entry
- Financial Services Accord, US-Japan, 1995
- Big Bang Mutual Fund Reform
 - Law Governing Securities Investment Trusts and Securities Investment Corporations, 1998
- Goldman Sachs, ranks 3rd at end of 1998

Foreign pension funds managers

- Foreign trust banks, 1985
- Foreign and domestic investment advisory firms, 1990
- Financial Services, Accord, US-Japan, 1995

Foreign finance companies

- GE Capital

Big Bang

- Diet enacted Financial System Reform Law (FSRL) on June 5, 1998, which was promulgated on June 15, 1998. The FSRL was an omnibus law, amending twenty-two separate financial laws.

**Challenges of the New International Financial
Architecture: Lessons for Asia**

Miss Jane K. Winn

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University of Hong Kong, Department of Law

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Jane K. Winn¹

Catalytic Impact of Information Technology on the New International Financial Architecture

- I. Introduction
- II. Changes in information technology
- III. Impact on Markets and Standards
- IV. Challenges to Global Financial Markets
- V. Conclusion

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- 1 ☐ **The Impact of Technology on Financial Markets and International Standards**
- 2 ☐ **Changes in Information Technology**
 - closed to open networks
 - mass participation
 - disintermediating technologies: Internet, smart cards
 - varying rates of innovation among markets
- 3 ☐ **Impact on Markets and Standards**
 - destabilization through disintermediation & globalization
 - stabilization from greater transparency
 - absence of relevant standards for system security
 - flexibility of risk-based standards to accommodate new risks
- 4 ☐ **Challenges to Global Financial Markets**
 - back office operations become front office
 - commodification of traditional services, intermediate new risks
 - risk/reward tradeoff between innovation and access in technological infrastructure
- 5 ☐ **Closed to Open Networks**
 - Banks and military were early adopters
 - Financial market automation based on legacy systems & closed networks
 - Interface between legacy systems and client/server networks and within new network information systems
- 6 ☐ **Mass Participation**
 - online brokerage accounts in securities markets
 - home banking
 - new markets in developing countries
- 7 ☐ **Disintermediating Technologies**
 - financial transfers must be cleared and settled by banks
 - user interface may be provided by non-bank, e.g. Yahoo
 - Smart cards - offline clearing
- 8 ☐ **Varying Rates of Innovation**
 - core financial markets have largest investment in legacy systems
 - core financial markets have broadest retail markets
 - emerging markets can move to newest technology
 - cell phone for the Grameen Bank
- 9 ☐ **Destabilization through disintermediation & globalization**

- mass market participation vs. institutional participation
 - regulation of banks creates competitive advantage for nonbanks
 - global integration of information technology
- 10 ☐ **Stabilization through greater transparency**
- Disclosure reaches broader markets
 - Even though crooks reach broader audiences, so do regulators
 - Eliminate disparities between pricing in different markets
- 11 ☐ **Standards for System Security**
- trustworthy means utterly reliable
 - trustworthy not based on cost/benefit analysis
 - commercially networked information systems exponentially more complex
 - no participant has a business model to provide adequate security
 - no standards to evaluate current network systems
- 12 ☐ **Adapt risk-based standards for new risks**
- Risk-based capital standards include operation risk as element
 - access/innovation create new operation risks that cannot be evaluated under current standards
 - Market & credit risk vs. security risks - who will disclose?
- 13 ☐ **Back office becomes front office**
- Unless management prioritizes, no progress
 - Security must be pervasive to succeed
 - New model for customer/institution interface
- 14 ☐ **Intermediate new risks in e-commerce**
- Who is counterparty? Should online contract be executed?
 - Banks are trusted third parties
 - Not telephone directory but letter of credit
- 15 ☐ **Opportunities and Challenges**
- Can Microsoft replace financial intermediaries?
 - Can regulators develop and harmonize standards fast enough?
 - Has the genie been let out of the bottle?

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I. Introduction

The sudden emergence of the Internet as a global network threatens to eclipse the importance of the global information infrastructure painstakingly built by financial institutions and their regulators over the past three decades. The open public nature of the Internet threatens the value of the closed proprietary networks developed by financial institutions which now face serious problems in integrating their legacy systems and new Internet systems. Information system security, once a dreary back office matter, is now central to the success of e-commerce business plans. Before financial institutions can capitalize on their expertise in information system security, they will have to overcome the serious problems that have recently emerged in security of their existing legacy systems.

The challenges posed to regulated financial markets by the sudden democratization of the global information architecture may be offset by competitive opportunities only if regulated institutions can adapt quickly and effectively to the rigors of this new environment. Regulators will have to find a middle path between stifling regulated entities and so permitting unregulated competitors to steal the show, and not maintaining the necessary prudential oversight of financial markets when the levels of risk investors are exposed to in financial markets are rising rapidly.

II. Changes in information technology

The recent acceleration in the growth of the global information economy caused by advances in information technology is challenging the ability of financial markets to adapt. The growth of global networked information systems create threats to the safety and soundness of financial markets because information and transactions can flow more quickly and easily across borders, destabilizing markets in more than one country, and resulting in more intense fluctuations in activity levels within each country. The rapid growth of networked information systems also creates threats to the security of financial market infrastructure if the trustworthiness of those networks is permitted to decline as their scope grows.¹

Decades ago, the design of secure networked computer systems was almost the exclusive province of military and financial institutions. The first large scale applications of sophisticated security technology using cryptography were developed in the military.² Banks followed close behind, designing secure communications systems to confirm funds transfers and other sensitive information. Banks today remain at the forefront of developing sophisticated security systems

¹National Research Council, Trust in Cyberspace (National Academy Press, Washington DC: 1999).

²For this reason, encryption is still regulated as a dual-use good in the export regulations of many countries, meaning that some restrictions apply to its export because it can be used for either civilian or military purposes. See Stewart A. Baker and Paul R. Hurst, The Limits of Trust: Cryptography, Governments and Electronic Commerce (Kluwer Law International 1998).

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for global electronic commerce,³ although the playing field is already thick with potential competitors.⁴

An earlier generation of bank automation was based on the use of mainframe computers and closed networks.⁵ One basic principal of computer security is that the larger the number of users a system has, the harder it will be to secure. It was not difficult to restrict access to the first generations of centralized, isolated mainframe computers. Subsequent generations of information technology were not so closed and hierarchical, however. Enterprises began granting access to more employees and permitting the exchange of more data between enterprises. When these networks were based on leased lines or other closed communications networks, it was still feasible to establish and monitor security within the existing standards for adequate computer security.

Today, the Internet has brought tens of millions of individuals into a global computer network. The Internet lacks any central authority or formal governing body, but rather is based on open, public standards and spontaneous decisions by millions of independent users. Until 1995, when the U.S. National Science Foundation ceased providing backbone services, the NSF acceptable use policy applied to any traffic on the Internet that might be routed through NSF facilities, and forbade commercial activity.⁶ The use of the Internet for electronic commerce thus only began in 1995. By 1998, electronic commerce between businesses over the Internet amounted to \$43 billion, while consumer transactions amounted to \$8 billion, with some analysis predicting the volume of business to business Internet electronic commerce to grow to \$840 billion in three years.⁷

This global integration and mass market reach is creating a huge potential market for

³See, e.g., Identrus, a joint venture of several major multinational banks that plan to provide a range of electronic commerce risk intermediation services. See <http://www.identrus.com/index.html>

⁴See, American Bankers Association press release on April 20, 1999 listing banking industry concerns with government electronic commerce security policies at http://www.aba.com/aba/ABANews&Issues/PR_042099INFO.asp

⁵For a discussion of how closed network electronic commerce differs from open network electronic commerce, see Jane K. Winn, Open Systems, Free Markets and the Regulation of Internet Commerce, 72 Tulane Law Review 1179 (1998). A copy of this paper is available at <http://www.smu.edu/~jwinn/esig.htm>.

⁶Id at note 25.

⁷Janet Bush, Online Revolution Tears Up Rulebook, The Times (London), February 10, 1999 (available in Lexis-Nexis News).

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financial services. Some new financial service providers are able to develop wholly new systems that are based on Internet standards and achieve rapid growth with low overheads as a result. The most dramatic progress in this area has been achieved with online stock trading through discount brokerage firms. Consumer migration to Internet based banking has been slower, and financial service providers have struggled to integrate Internet access and functionality with their existing legacy systems. This means setting up firewalls, proxy servers, virtual private networks, and possibly even a public key infrastructure.⁸ Monitoring network security within a closed network is not easy, but it is not nearly as difficult as trying to manage access control and other security policies when tens of thousands of retail customers may be permitted to login to a computer system. For example, a large number of unsophisticated users will make innocent or inadvertent attempts to exceed the limits of the access rights they have been granted. The large number of such attempts that occur unintentionally may mask attempts by sophisticated intruders to breach network security.⁹

One trend in electronic commerce applications today is the bundling of new products or services in order to enhance the value of a service. With increased the increasing complexity of services offered comes greater complexity in the risk management process associated with those services. In addition, advances in technology permit a greater volume and velocity of transaction processing to take place.¹⁰ If responsibility for security for new projects that involve substantially greater risk than earlier undertakings is not clearly assigned, or the implementation of security seems to undermine the chances for attaining the desired business objective, adequate security may never be put in place. For example, the design of secure applications using encryption technology can be very slow, expensive and difficult. Because they are so complex, encryption applications are likely to contain design flaws that can only be discovered through extensive, expensive testing. Once installed, security based on encryption offers no perceptible benefits to users, but often substantially degrades system performance, resulting in higher levels of user dissatisfaction with the process. Given that designing and implementing appropriate security will slow down a project, make it more expensive and less appealing to users more concerned with convenience than security, no one will volunteer to take responsibility for such a thankless task unless the mandate to do so is absolutely clear from the highest levels of management.¹¹

⁸For a discussion of public key infrastructure, see Benjamin Wright and Jane K. Winn, The Law of Electronic Commerce, Aspen Law & Business (3rd ed.. 1998; 1999 supplement), Chapter 3.

⁹Nick Lockett, How to secure electronic transactions, International Financial Law Review, March 1999 at 10.

¹⁰Robert Simons, How Risky Is Your Company?, Harvard Business Review, May-June 1999 at 90.

¹¹See Trust in Cyberspace at 17

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These increased risks to information system security are counterbalanced at least in part by greater economic opportunities by the mass market created by the vast number of Internet users. If regulated financial intermediaries do not act decisively to anticipate the needs of consumers logging onto the Internet, unregulated intermediaries will have a window of opportunity to develop competing products. Automating bank-customer relationships offers banks opportunities for reducing the cost of customer service while raising the level of customer satisfaction with the service received. New technologies not based on personal computers such as smart cards or smart telephones may also play a decisive role in defining the markets for financial services in the future. However, some new technologies, such as smart cards, may find more markets in developing countries than they have to date in the United States where markets for electronic financial services are often quite mature and customers may have little incentive to adopt newer technologies.¹²

III. Impact on Markets and Standards

New information technologies are rapidly unsettling well established business models based on the services third-party intermediaries in executing transactions. Some of the traditional intermediaries in addition to banks and brokerage adversely affected by new technologies firms include postal services, retailers, real estate agents, auctioneers and travel agents. For example, the volume of airplane ticket sales purchased through independent travel agents in the US is falling rapidly, from 80% in 1996 to only 52% in 1998,¹³ as the former customers of travel agents are empowered to locate the tickets they want themselves using such Internet services as Travelocity, the web interface for the SABRE airline computer reservation service.¹⁴ Banks have faced challenges from disintermediation for many years, as alternatives to bank services such as securitization of corporate debt and money market funds for individuals eroded some of their core customer base. A rapid expansion of access to networked information systems by bank customers increases the number of bank services that may be disintermediated. Unlike some other groups facing the threat of disintermediation, however, regulated financial institutions often enjoy a legal monopoly over some core services that generally cannot be provided outside the regulated banking system.

¹²For a discussion of some of the reasons US consumers have resisted adopting new electronic payments technologies, see Jane K. Winn, Clash of the Titans: Regulating the Competition between Established and Emerging Electronic Payment Systems, in *The Legal and Policy Framework for Global Electronic Commerce: A Progress Report Symposium Issue*, Berkeley Technology Law Journal (forthcoming spring 1999). A copy of this paper is available at <http://www.smu.edu/~jwinn/clashoftitans.htm>.

¹³E-Commerce soon to show benefits, *The Toronto Star*, February 9, 1999 (available in Lexis-Nexis News).

¹⁴Travelocity can be accessed at <http://www.travelocity.com/>. Expedia is a similar service offered by Microsoft and can be accessed at <http://expedia.msn.com/daily/home/default.htm>.

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Payment systems are a prime example of a process that cannot generally be provided outside regulated financial intermediaries. Regulated financial institutions generally enjoy a monopoly over deposit accounts and payment services related to them such as check processing. Non-bank competitors have begun to nibble away at the value of the core franchise that banks retain, however, and this process can only be expected to intensify with advances in information technology. Credit cards technically permit the cardholder to access a line of credit rather than providing a clear cash equivalent, but are now widely accepted in the US as a standard form of payment. Non-bank issuers are significant competitors of banks in the market for issuing credit cards. The same risk of partial migration of traditional banking services away from banks as the core providers is also present in Internet financial services markets. If Microsoft had succeeded in purchasing Intuit, the most popular personal financial management software program in the US, Microsoft could easily have purchased a small bank located in some state with favorable banking laws and used that regulated entity for all its basic clearing and settlement functions. All the more complex forms of customer service that might be more profitable than simple clearing and settlement processing would have been done outside the bank in an environment controlled by Microsoft, not the bank. So the existence of limited forms of government monopoly for certain financial services is no guarantee of profitability for any financial institution taking advantage of that monopoly.

While new information technologies permit disintermediation, they also permit reintermediation. The humans using the technology often need integration or sorting services to make sense of the bewildering array of goods and services now offered over the Internet. Consumers may not be able to articulate their need for someone to integrate disparate new services into a meaningful package. The enterprise that correctly identifies those unarticulated needs among individuals willing to use the Internet to find goods and services, however, can establish a profitable electronic commerce business. "Portals" are examples of integrators that are rapidly gaining popularity among Internet users today. Yahoo.com and other portals offer an array of services consumers are likely to need, and permit individuals to customize the interface they find when dealing with the portal. Businesses that are able to establish relationships with portals can gain access to large numbers of potential customers, while businesses that attempt to operate in isolation from these new Internet intermediaries will need considerable name recognition to offset the appeal of portal services.

Internet bill presentment and payment is an example of a service that could be offered either by banks or by new technology companies such as those that offer portals. It is extremely unlikely that consumers or businesses will be willing to log on to many different websites to pay each of their different monthly bills online. Billers are unlikely to be successful in automating their billing processes if they rely on their customers to find the biller's website and authorize electronic payment from that location. Rather, both retail and business bill payers are likely to prefer to seek out an intermediary who can display for the payor a large number of bills and process payment instructions. This new form of intermediary could be a bank or it could be another type of intermediary who merely purchases access to an automated clearing house to provide payment functions. Checks are the dominant method of bill payment in the US today,

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and checking accounts are the exclusive domain of regulated financial intermediaries. If banks are going to remain the principal intermediaries between billers and payors, they will have to develop competitive bill presentment and payment services or see their check collection franchise erode while competitors offer into new Internet services to take its place.

Extremely sophisticated technologies offer the possibility of further disintermediating banks from even their role of providing settlement for payment services. Some smart card services remain linked to customer accounts maintained at regulated financial institutions, but some do not.¹⁵ The Mondex smart card is the most noteworthy example of a smart card that can transfer value between cards offline without relying on the clearing services of a financial intermediary. The spread of such systems raises profound challenges for financial market regulators, as well as law enforcement authorities who rely on money laundering prosecutions as a chief weapon in fighting organized crime. The movement of substantial amounts of money in digital format outside regulated financial intermediaries threatens to make existing forms of financial market regulation and law enforcement activity ineffective. To date, however, the slow rate of adoption of such technologies in the marketplace and the cooperation of developers of such technologies with regulators have kept such risks under control.¹⁶

The rate with which new technology is being adopted varies across countries and regions. Financial markets in developed countries may already have considerable information technology infrastructure, but this may hinder the development of new technology as well as promote it. Financial institutions in the US have huge investments in legacy systems that are very stable and inexpensive to operate now that they have been fully depreciated. The availability of these legacy systems may impede the introduction of new services. This seems to be happening in the competition between the relatively simple magnetic stripe card for accessing a bank or credit card account, and smart cards, which offer the promise of a much richer interface between the user and the financial institution, but which cannot be used until merchants and financial institutions are willing to make a huge new investment in technology. Smart cards are much more popular, by contrast, in some European and Asian countries, and may find their greatest market in developing countries such as China which have not yet made much progress in automating financial services.

¹⁵In 1996, the US Federal Reserve Board recommended revisions to its Regulation E governing electronic funds transfers to cover what it labeled “accountable” cards, but not “unaccountable” smart cards. In response to Congressional criticism, however, the Fed withdrew the proposal to regulate smart cards. See Electronic Funds Transfers, 61 Fed. Reg. 19,696 (to be codified at 12 C.F.R. pt. 205)(proposed May 2, 1996); Board of Governors of the Federal Reserve System, Report to the Congress on the Application of the Electronic Funds Transfer Act to Electronic Stored-Value Products, available at http://www.bog.frb.fed.us/boarddocs/RptCongress/efta_rpt.pdf.

¹⁶See the articles in the symposium on the Electronic Future of Cash in the American University Law Review, April 1997 issue for a complete discussion of these issues.

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Although Internet access around the world is rapidly increasing, over 50% of all Internet users still lived in the United States in 1998.¹⁷ The majority of Internet electronic commerce is also centered in the US and is likely to be so for the near future, although the European Union and many Asian countries are working to promote electronic commerce in their domestic economies.

Internet access may be difficult for potential users in developing countries, but the obstacles to access created by the difficulty of operating a personal computer will diminish as computing functions are transferred to more and more portable and wireless devices. As network access becomes possible through devices that are easier to use and more stable, developing countries may benefit from the opportunity to adopt the most sophisticated technology, skipping over intermediate or outmoded technologies. For example, the Grameen Bank, a community development bank in Bangladesh that emphasizes microlending programs, is distributing cell phones throughout Bangladesh to village women who sell calls on the cell phones by the minute to pay for them. Such village telephone services may soon upgrade to include Internet e-mail access which would give villagers an inexpensive medium of communication with relatives abroad.¹⁸ When the next generation of smart telephones becomes available, the same distribution system may promote the rapid spread of modern financial services to some of the world's poorest regions.

When global financial markets operated over the legacy systems maintained by regulated financial institutions, they posed serious threats to the stability of national financial markets. The magnitude of those threats only increases when the relatively stabilizing influences of institutional intermediaries are removed and unsophisticated individuals participate in markets through intermediaries that offer minimal content or guidance. For example, the US Securities and Exchange Commission has struggled to control a rising tide of securities fraud perpetrated over the Internet with repeated sweeps of Internet sites and a rising volume of enforcement actions.¹⁹ Notwithstanding major efforts by regulators and others, the number of gullible investors has not stopped growing, creating opportunities for promoters touting worthless stocks to reap quick gains. The same kind of unsophisticated and uninformed investor who might lose money in a scam investment scheme can also destabilize larger market trends by rushing in or out of the market based on rumors or misperceptions.

¹⁷Number of Internet Users Increasing: Philippine Study, Asia Pulse, March 3, 1999 (available in Lexis-Nexis News). This study found that the worldwide number of households accessing the Internet at least once a week grew from 61 million in 1996 to 147 million in 1998, and was expected to grow to 320 million in 2000 and 720 million in 2005, by which time only 29% of Internet users would be found in the US.

¹⁸Manjeet Kripalani, Taking the Isolation out of Poverty, Business Week, May 3, 1999 at 136.

¹⁹Information about the most recent sweep is available on the SEC's website at <http://www.sec.gov/news/nets0599.htm>.

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Regulated financial intermediaries can only stabilize the operation of global markets if they retain a significant share of those markets. If regulated financial intermediaries are hobbled by burdensome regulations designed to protect the public when the public had few alternatives to regulated financial services organizations, they may be powerless to stop the erosion of their market share in favor of unregulated competitors whose operating costs are lowered by lower costs of compliance with regulations. Regulators face a difficult task in deciding whether to lighten the regulatory burdens now imposed on financial institutions to permit them to compete more equally with non-banks for a share of the Internet electronic commerce market, or whether to try to regulate the new entrants to the marketplace. The current climate of deregulation in the US and elsewhere will make it difficult to create new regulations to govern Internet commerce outside of a few field.²⁰

Regulators may have few alternatives to using the greater access provided by global networked computer systems as an important tool in working to make markets operate more efficiently and safely. The same access enjoyed by market participants will permit regulators to disseminate information that market participants need to make sensible decisions and to protect themselves. If markets do actually become more efficient, then many of the traditional bases for regulatory activity may diminish. Furthermore, as the US SEC emphasizes, the Internet not only gives crooks a way to find gullible investors, it gives law enforcement authorities a way to find the crooks as well.

IV. Challenges to Global Financial Markets

The global integration of information technology may be quite novel in some areas of economic activity, but financial market regulators have struggled with these issues for decades. Financial markets can be thought of as the first organized, global information markets operating through networked computers. Financial market regulators may therefore find their problems intensifying, but not particularly novel. This is in marked contrast with other information economy markets that now operate globally due to advances in information technology. Entertainment and publishing industries faced problems of piracy that seemed very significant before the creation of a global, mass market networked information system over which content could be reproduced virtually instantly, costlessly and infinitely. Intellectual property rights owners are now struggling to find ways to upgrade the infrastructure of the network to support

²⁰Various governments and transnational organizations have stated that no new regulations should be imposed on the Internet without good cause shown. These include The Framework for Global Electronic Commerce, available at <http://www.whitehouse.gov/WH/New/Commerce/index.html>; A European Initiative in Electronic Commerce, available at <http://www.cordis.lu/esprit/src/ecomcom.htm>; the OECD report A Borderless World: Realizing the Potential of Global Electronic Commerce, available at http://www.ottawaoecdconference.org/english/announcements/e_actionoced.pdf; and the WTO Declaration on Global Electronic Commerce, available at <http://www.wto.org/anniv/ecom.htm>.

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new digital rights management technologies to bring the threat of global piracy under control.

Financial market regulators do face new challenges in maintaining the security of global financial networks, however. As cryptography has moved from the shadowy world of military and bank security, government controls over the use of cryptography has become a political issue.²¹ In the US and elsewhere, governments have tried to restrict exports of powerful cryptography and to restrict mass market distribution of encryption technologies that might interfere with the ability of law enforcement to monitor communications. Individuals and groups concerned with the preservation of traditional civil liberties in online environments have responded by attacking the weaker encryption products that government are more willing to permit to be widely used. As a result, breaking the encryption technologies that form the backbone of today's financial market infrastructure has become a political cause among civil libertarians who have largely succeeded.²² Financial institutions now face the challenge of upgrading their security infrastructure, and making sure that the public believes in its continued safety.

Many financial institutions have actively pursued new information security technology for strategic advantage in recent years. Several major international banks recently combined to form Identrus,²³ a electronic commerce trust organization designed to keep bankers as the intermediaries for global electronic commerce. Zions Bank in Utah got permission from the Office of the Comptroller of the Currency to become a certificate authority under Utah's digital signature law.²⁴ Banks in the US have been involved in many electronic commerce pilot projects through the work of trade associations such as BITS, the Banking Industry Technology Secretariat.²⁵

While some financial institutions may be able to leverage their current expertise into a

²¹See, Jane K. Winn, Cryptography and Electronic Commerce: Update on Recent Developments, Journal of Internet Law __ (April 1999) and Baker and Hurst, supra, note xx.

²²In January 1999, a group managed to decipher a message encrypted with a 56 bit key in 22 hours and 15 minutes. The group used a specially designed supercomputer and a world-wide network of nearly 100,000 personal computers on the Internet. See "RSA Code-Breaking Contest Again Won by Distributed.Net and Electronic Frontier Foundation" available at the Electronic Frontier Foundation website at http://www.eff.org/pub/Privacy/Crypto_misc/DESCracker/HTML/19990119_deschallenge3.html

²³Information about Identrus is available at <http://www.identrus.com>.

²⁴OCC Letter dated 1/12/98, available <http://www.occ.treas.gov/ftp/release/98-4att.pdf>

²⁵Information about BITS is available at <http://www.bankersround.org/>

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strategic advantage, many financial institutions may confront difficult decisions about new technologies without any strategic vision to guide them. Financial institutions will have no choice but to upgrade their technological infrastructure in the coming years, but are confronted by a competing array of putative successors to the leading products and services available today. Standard setting organizations and financial industry trade associations are struggling to develop new standards to guarantee interoperability as well as security, but without any clear winners yet in many fields.²⁶

Even standard developing organizations, with their greater access to technological expertise than many individual financial institutions, confront serious problems in trying to identify appropriate new technologies to create a secure and stable information infrastructure for financial markets. The most developed US standards for information system security were developed for use by the military where cost-benefit balancing was not a major factor.²⁷ As a result, concepts such as “trustworthy” imply the highest feasible level of security, not the most appropriate level of security in light of financial constraints. In moving to a market-based standard for system security in which cost-benefit decisions must be made explicitly, fundamental questions about appropriate system security design have no clear answers. This leaves those making technology acquisition decisions without concrete guidance on practical questions about what models of security are appropriate for different business functions.

Financial institutions thus face a future of rapid technological innovation, increasing competition from less regulated competitors, increasing information system security risks, and no clear answers regarding what technological solutions are appropriate. These risks are not utterly dissimilar to many of the risks financial institutions have always faced, however. These new risks may still be assimilable into the existing regulatory framework, such as risk-adjusted capital standards. Operations risk is an element of the risk-adjusted capital calculations, and many of the new information economy operations risks are substantially similar in type if not in degree to operations risks present in global financial markets operated using different networking technologies. The existing framework of regulatory oversight of financial institutions creates an environment within which many of the currently unresolved issues may actually be addressed responsibly.

Risk from fluctuations in market interest rates or credit failures are nevertheless different than security risks in certain important respects. One important respect is the ability of those

²⁶For a list of various electronic payment standard setting initiatives, see the European Union Open Information Interchange (OII) project Electronic Payment Mechanisms web site at <http://www2.echo.lu/oii/en/payment.html>. For a collection of web resources relating to electronic payment issues, see the American Bar Association Business Law Section Cyberspace Law Committee Electronic Financial Services Subcommittee web site page on payments at <http://www.abanet.org/buslaw/efss/home.html>.

²⁷See Trust in Cyberspace, supra note xx.

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who suffer failures in information system security to suppress information about the failure. Disclosure of failures is essential to the development of more secure systems, yet any financial institution foolhardy enough to disclose publicly that failures have occurred in its system will suffer a loss of public confidence in its services. Because of the very real incentives for nondisclosure of information about known threats to information system security, the US Critical Infrastructure Project is designing a reporting system that permits the identity of the party disclosing a breach in security to be hidden while a database of known breaches is built for the benefit of those designing secure systems.

Before the magnitude of the risks posed by new information technology can be adequately addressed within global financial markets, there is a need for the management of individual institutions to set priorities that reflect the importance of information system security. One of the characteristics of the information revolution is the sudden rise in prominence within organizations of business processes that were once thought of as mere plumbing. What were once thought of as “back office” operations designed to support other business activities are now tied directly to profitable activities. For example, the rise of data warehousing and data mining as activities designed to identify new market opportunities changes the focus in electronic commerce implementation from cost savings from increased efficiencies in back office operations to more successful marketing and customer service.²⁸ In the next generation of Internet electronic commerce, some of the most successful applications will be those that integrate sophisticated information technologies with old and new business models to produce new forms of interaction with customers online. Success in these arenas will require critical thought about not just the opportunities offered by new technologies, but prudent management of the risks entailed by acting on those new opportunities.

V. Conclusion

Financial institutions were at the forefront in creating the global information economy as it exists today. New information technologies are creating new opportunities and new challenges for regulated financial intermediaries. Those that can adapt quickly and often to the rapidly changing environment of global electronic commerce may survive and prosper, but many competitors from outside the traditional financial services industries are designing systems that try to eliminate or minimize the role of financial institutions. Not only must financial institutions be competitive in this very dynamic environment, they must grapple with rising uncertainty about the security of their core operations. National regulators and standard developing organizations will play an essential role in deciding who succeeds in this new environment, but they will have to struggle to strike an appropriate balance in the midst of such rapid change.

²⁸For a discussion of data mining, see Peter Cabena, et al., Discovering Data Mining, 1998.

**Regulation and Private Law in OTC
Derivatives Litigation**

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Regulation and Private Law in OTC Derivatives Litigation

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By
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Introduction

In the timely Conference on the New International Financial Architecture, held under the auspices of the Faculty of Law of the University of Hong Kong, the issue of derivatives has been raised by speakers on a number of occasions. Derivatives have only played a major part in banking and finance for the last ten to fifteen years. During that time the volume and diversity of these instruments has increased enormously. Despite that fact, it is only now that derivatives are receiving attention from legal commentators. Perceived risk and systemic concerns have already resulted in sustained interest from the regulators in all leading jurisdictions. However no consensus of treatment by regulators has emerged, and regulation remains patchy. Major policy issues remain unresolved, though supervisory authorities have been constrained to facilitate rescue operations in various countries (eg the New York Fed in the case of Long Term Capital Management, and the Bank of England in the case of the much smaller acquisitions of Barings by ING).

At the most basic level, there is no universally valid definition of derivatives for legal purposes. There is a clear distinction between exchange-traded instruments and “over the counter” (OTC) derivatives. Exchange-traded instruments, such as the futures and options traded on exchanges functioning in many different financial centres worldwide, are standard contracts with established settlement procedures and the exchange or its nominee may be the counterparty.

OTC derivatives, on the other hand, are bilateral contracts individually negotiated between two parties. They cover a vast range of potential transactions. As one commentator puts it, these are individually negotiated bilateral notional amount agreements including swaps, providing for cash flows based on movements in interest, currency, equity, commodity or other indices (or a combination thereof) and swap-related products which are, or have certain characteristics similar to, options (including caps, floors and OTC options on those indices or on securities or commodities themselves) (Credit Derivatives, Schuyler K Henderson, (1998) 8 JIBFL). A recent example is the development of so-called credit derivatives. In one form, these are contracts by which two parties (typically financial institutions) agree mutual obligations in the event of default by a reference entity. For example, in the event of a failure to meet its obligations by the reference entity, one party may be required to take up from the other party debt issued by the reference entity at a pre-agreed price.

This paper is solely concerned with OTC derivatives. These are used for both hedging and speculative purposes. A credit derivative, for example, is described as a “synthetic investment”, since it is essentially a contract by which one party takes on a credit risk by reference to the reference entity. This illustrates the extent to which financial obligations have developed a life of their own. In the classic banking transaction, the financial institution lends to a particular party. A contractual relationship thereupon comes into existence between lender and borrower. The lender will be concerned with the borrower’s credit worthiness, and issues such as documentation and security will be paramount. The bilateral relationship will continue through the life of the loan, and may include workouts in case that the borrower gets into financial difficulty. In the case of a credit derivative, on the other hand, the relationship with the borrower has entirely disappeared. The default upon which the instrument is payable is entirely outside the control of the contracting parties, who may not even initially know about it. This plainly is a unique contractual creation. It typifies what is perhaps the central feature of OTC derivatives,

namely the de-coupling of the parties' respective obligations from the point of reference by which those obligations are measured

Over time, this type of contract may be expected to raise issues not normally encountered in contractual relations. At the simplest level, the contract needs to be spelled out in fine detail since it is a purely artificial construct. This has, in fact, widely occurred in practice. The making of the contract is often quite informal, with basic terms agreed between the parties through an electronic medium. These are then confirmed in a brief confirmation document which sets out the vital features of the transaction. This in turn may be subject to a much more detailed master agreement often in standardised form, eg the ISDA form (ISDA being the International Swaps and Derivatives Association). The master agreement may itself refer to standard terms, such as the ISDA definitions. Whilst ISDA has played an outstanding role in this regard, the result is often a complex contractual structure which is not always easy to construe.

There is now an increasing volume of litigation concerning derivatives. There are sometimes regulatory issues directly involved, for example, whether the contract concerned is a controlled securities or commodity contract, or has been entered into in breach of conduct of business rules. As this paper shows, regulatory standards may also influence the way a court decides a particular case. Those instances aside, the courts treat derivatives in the same way as any other contracts. However, there is now sufficient experience to identify some of the salient features that can be expected to recur in this type of case. The attitude of the courts in deciding derivatives disputes will be of great interest to regulators, because ultimately this will create the legal environment in which the markets operate. Already certain judicial trends can be discerned, particularly in the London and New York courts. These are described in a comparative form below.

Classification of litigation issues

As will be seen, the factual background to the litigation has varied. It has resulted where unexpected movements in the underlying subject matter of the transaction have caused a large loss to one side (and a large profit to the other). In one sense volatility is the *raison d'être* of a derivatives transaction, though their overall effectiveness as a hedging tool may sometimes be questioned. Excessive volatility can cause problems on a considerable scale. The Russian financial crisis of August 1998 is an example, and has resulted in litigation on quite a large scale, though at the time of writing there have been no authoritative decisions by the courts, and financial institutions have often been reluctant to press disputes to a hearing. Unlike most other financial transactions, derivatives transactions in the Russian context often contain an arbitration clause (eg a reference to the London Court of International Arbitration). There is a practical reason for this, in that Russia is a party to the New York Convention on the enforceability of arbitration awards, so that in theory an arbitration award should be easier to enforce than a judgment. It is unclear the extent to which arbitration machinery has, in fact, been used.

Private law liability issues vary considerably in their scope. The authority of the counterparty is sometimes an issue. Assuming authority, the construction of the contract and its true meaning may be the core of the dispute. Construction issues can arise in many different forms; some examples are given below. In practice, it is believed that disputes will very often turn on questions of construction. When difficulties appear, it is not unusual for organisations such as ISDA to amend their standard terms, though naturally this does not operate with retrospective effect as regards the parties to a particular transaction. The effect of alleged (or admitted) pre-transaction representations are an issue in some cases. Suitability may also be a central issue, though in practice this is analysed in accordance with legal concepts such as duty of

care and advisory or fiduciary duties. The effect of disclaimers may also arise. Reference to regulatory issues have already been made.

ISDA master agreements of the kind under discussion offer a choice of governing law, eg a choice between English and New York law. The terms are designed to be effective under both legal systems. Jurisdiction follows the choice of law. The English and New York courts have both upheld such choice of law and jurisdiction clauses, and have been prepared to grant an anti-suit injunction restraining the use of legal proceedings in a different jurisdiction contrary to the terms of the agreement (*Bankers Trust Co v PT Jakarta International Hotels & Development*, unreported, Com Ct, 12 March 1999).

Capacity

Capacity concerns the power of a corporation to enter into contracts. Rules vary widely between legal systems, and between private and public corporations. The capacity issue arose starkly in the local authority swaps litigation in England and Scotland. It was held by the courts that interest rate swaps contracts entered into by local authorities with banks and other financial institutions were void as falling outside the statutory powers under which local government was entitled to raise money. The litigation is now over, and following the initial ruling there were numerous issues that arose as to the consequences of lack of capacity which, it will be noted, rendered the contracts void ab initio. In summary, whilst the contracts were unenforceable against the local authorities, they were required to return payments themselves received [with compound interest] under general restitutionary remedies. In retrospect, the universal assumption that contracts on the scale involved were within the powers of the authorities concerned may seem surprising. However, the significance of swaps litigation is that it focused attention on the legal risk that a derivatives transaction [like any other transaction] may give rise to. The result of

the litigation was seen as unfair and damaging in the markets, and gave rise to considerable efforts to restore confidence. The fact that despite the invalidation of these local authorities' transactions the volume of English law-governed contracts continued to soar is evidence of general market confidence in the reliability of the English courts. So far as it is known, the capacity issue has not arisen in the same form under New York law.

Formality

Under English law, there are no formal requirements. There is no necessity, for example, for a written document signed by an authorised signatory. In case of dispute, either as to the existence of the contract or its terms, the court determines the position according to the available evidence.

Authority

A corporation can only act through its duly authorised employees and agents. It is not uncommon for a corporation which has incurred heavy losses in a derivatives transaction to contend that the transaction was outside the authority of the employee concerned. As already mentioned, this is a substantive question, not a question of formality. Authority issues are normally resolved under the doctrine of apparent authority, so that if the employee concerned appears outwardly to have the requisite authority the corporation will be bound. In litigation in New York between Societe Nationale d'Exploitation Industrielle des Tabacs Allumettes [SEITA] and Salomon Brothers, the facts concerned two currency swaps entered into in early 1994. The swap products included one based on the deutschemark interest rate [the DEM swap] and one based on the exchange rate between the U.S. dollar and Japanese yen [the USD/JPY swap]. The swaps were restructured soon thereafter, and were terminated in December 1994-January 1995

with a loss to SEITA of approximately US\$30 million. One of SEITA's claims was premised on the allegation that the bank executed the swaps transactions even though it knew or should have known that its Treasurer could not enter into the transactions without the prior approval of its superiors. Under New York law, as a general rule, a corporation is bound by the conduct of its officers acting within the scope of their actual or apparent authority, and that corporate treasurers must be regarded as having broad authority to commit his or her company in financial dealings. The Court reviewed a document entitled "Delegation of Powers" which entrusted the treasurer to manage plaintiff's treasury and negotiate treasury investments, and contained no limitation on the type of investments, derivatives or otherwise, that the treasurer could approve. The plaintiff argued that the treasurer's powers under the Delegation document were limited by a corporate resolution which required board approval of financial transactions "of an innovative nature or presenting particular risk in relation to techniques currently used." The Court found that even if the swaps in question were arguably "innovative" for the plaintiff, the plaintiff had not established that it actually subjected its treasurer to the purported review or authorization procedures with respect to swaps during the relevant period, or that it communicated its internal procedures to third parties. See *Societe Nationale d'Exploitation v. Salomon Brothers International et al.*, 1997 N.Y. Misc. LEXIS 706, at *9 (Sup. Ct. N.Y. Jan. 14, 1997). The Court found that the evidence showed that plaintiff's treasurer had actual or at least apparent authority to bind plaintiff to the swaps transactions, and that even if he did not, the plaintiff ratified the transactions. *Id.* at *8. Although the record contained facts which suggested that the bank may have contacted plaintiff's higher management out of concerns that the plaintiff might attempt to rescind the transactions as unsuitable, the end result of those communications was a ratification of the transactions. *Id.* at *10. The result would have followed precisely the same analysis had the case been tried under English law.

Illegality

One issue that has arisen from time to time is whether a particular transaction may fall within statutory provisions rendering gaming contracts unenforceable. Under English law, the matter is largely academic. It is believed that these transactions would not be characterised as gaming or wagering contracts, and in any case there is specific statutory provision disapplying the Gaming Acts in the Financial Services Act 1986.

Misrepresentation

A misrepresentation can be innocent, negligent, or fraudulent. In principle, the right to rescission arises, though the quantum of damage recoverable may depend on the degree of fault involved. In *Bankers Trust International plc v PT Dharmala Sakti Sejahtera*, a decision of the English Commercial Court given on 29 November 1995 involving derivatives, the Court held that although misrepresentations had been made, there had been no reliance. In the New York *SEITA* litigation, in evaluating SEITA's claim of fraud, the court held that the merger clauses in the ISDA master agreement precluded claims of oral misrepresentations and reasonable reliance thereon. The merger clause in the master agreement stated "[T]his agreement constitutes the entire agreement and understanding of the parties with respect to its subject matter and supercedes all oral communications and prior writings with respect thereto." The court dismissed the plaintiff's claim to have relied on misrepresentations as contrary to the evidence. A comparison between the two cases is of considerable interest because of the similarities of the factual background [the *Dharmala* case involved leveraged interest rate swaps as opposed to currency swaps]. The analysis was similar, though in *SEITA* the misrepresentations were alleged to have been fraudulent. Generally speaking, alleged fraudulent misrepresentations appear to

have been raised relatively frequently in New York litigation. For example, such allegations featured [generally unsuccessfully] in litigation concerning collateralized mortgage obligations [CMOs] which bear many of the same complexities of derivatives. See, e.g., *Olkey v. Hyperion 1999 Term Trust, Inc. et al.*, 98 F.3d 2 (2d Cir. 1996), cert. Denied, 138 L.Ed.2d 194 (1997):

Disclosure

There are rarely duties of disclosure implied by law outside certain particular categories of contracts [for example, insurance contracts and guarantees]. The English Court of Appeal recently reaffirmed that in the bank-customer context a duty of disclosure does not normally arise though there was no detailed analysis. *Fennoscandia Ltd v Clarke*, [1999] 1 All ER [Comm]. In the *SEITA* litigation, the Supreme Court of New York, Appellate Division, held that the “disparity of knowledge” between plaintiff and defendants did not in the circumstances impose a duty of disclosure upon the defendants. *SEITA v. Salomon Brothers International et al.*, 674 N.Y.S.2d 648, 649 (N.Y.App.Div. 1998). New York law in general, however, appears to recognise wider disclosure duties than would exist under English law. Nonetheless, whatever the legal requirements, disclosure is desirable as a matter of good practise where information relevant to the transaction is within the knowledge of one party only.

Advisory duty

Issues of suitability [i.e., the suitability of the product concerned for the counterparty] have tended to be analysed in terms of advisory duties. Unlike contracts for the sale of goods, there are no inherent warranties of suitability. A key feature of regulatory policy in both London and New York has been to stress the arms length nature of derivatives transactions. In summary, the policy view appears to be that if advice as to suitability is required, that function should be

explicitly recognised in the documentation. The *Wholesale Transactions Code of Conduct*, devised under the auspices of the Federal Reserve Bank of New York in August 1995, is a voluntary code of best practices for OTC derivatives transactions. The Code of Conduct applies to all participants in the wholesale financial markets that choose to adhere to them, including dealers and end-users of OTC derivatives (collectively referred to as “participants”). The Code of Conduct requires that a participant have the capability, either by itself or through an independent professional advisor, to understand and make independent decisions about OTC derivatives transactions. The Code of Conduct asserts the position that the relationship between Participants is arms length in nature, and that a Participant will not rely on the recommendation of its counterparty unless specifically provided otherwise. Thus, a Participant that desires to rely on its counterparty for recommendations should enter into a written agreement with the counterparty to that effect. In the absence of a written agreement, a Participant should expect that its counterparty will assume that the Participant has the capability to understand and make independent decisions about a transaction and will conduct its activities accordingly. Therefore, the Code of Conduct does not impose a suitability standard on Participants. The drafting committee of the Code of Conduct generally opined that an obligation to determine suitability of transactions for a counterparty would create duties and responsibilities that are unavoidably vague in scope and conflict with the arms length nature of the transactions. The drafting committee viewed suitability standards as being incompatible with the central concept of the principle that encourage participants to take responsibility for their own decisions regarding transactions. Participants are thereby encouraged to seek independent advice or otherwise enter into a written advisory agreement if they are unable or unwilling to take responsibility for decisions relating to OTC derivatives transactions.¹ Of course, given the degree of information asymmetry involved

¹ Counterparty Relationship in ISDA Master Agreements. The International Swaps and Derivatives Association (“ISDA”) has developed a form of “Representation Regarding Relationship Between Parties” pursuant to which each counterparty is deemed to represent, with respect to a given transaction as part of an underlying OTC derivatives master agreement, that (1) it has made its own independent decision to enter

in many complex OTC derivatives instruments, it is often difficult to surmise who has the obligation to clarify the nature of the relationship, the derivatives dealer or the end-user.²

The London Code of Conduct adopts a similar arms-length approach. This approach also appears in the case law. The two English decisions of *Dharmala* and *Fennoscandia* already noted reject the existence of advisory duties within the general context under discussion. On the other hand, it is important in this context to keep firmly in mind that the facts of individual cases and individual transactions vary enormously. An analysis which is appropriate for a transaction concluded electronically between two financial institutions may be inappropriate where the facts make it clear that the counterparty was relying on the derivatives provider for guidance and advice. Where that is the situation, disclaimers in the documentation may have limited effect. If the true relationship between the parties is one of reliance, the court may evaluate advice given by objective standards of due skill and care. In this context, the relative sophistication of the two counterparties may be in effect determinative.

Fiduciary duty

A fiduciary relationship implies a relationship between two parties characterized by features such as confidentiality, unequal bargaining power, trust, and reliance. In neither New

into that transaction and as to whether that transaction is appropriate or proper for it based on its own judgment and upon advice from such advisors as it has deemed necessary; (2) it is capable of evaluating and understanding on its own behalf or through independent professional advice and understands and accepts the terms, conditions, and risks of that transaction; and (3) it is also capable of assuming, and assumes, the financial and other risks of that transaction.

² Notably, the National Association of Securities Dealers ("NASD") does impose a fairly rigorous suitability standard on its member institutions, but a dealer does not have a suitability obligation towards those institutional customers that have the ability to evaluate investment risk and that exercise independent judgment. See 61 Fed. Reg. 44,100 (Aug. 1996) (NASD Suitability Interpretation). In approving the NASD Suitability Interpretation, the SEC agreed with the NASD's determination that defining "institutional investors" based on financial criteria and excluding those that qualify as "institutional investors" from the protection of the suitability rule would arbitrarily discriminate against institutional investors based on asset size, portfolio size, or institutional type, which were not necessarily determinative

York nor English law is the existence of a fiduciary relationship capable of precise definition. Since a fiduciary must put the other party's interests ahead of his own, such a relationship should in principle be rare in the commercial context. In practice, it has tended to arise in specific contexts such as discretionary fund management. It is submitted that the fiduciary concept is sometimes erroneously invoked in circumstances in which the real issue is the extent of the contractual obligations owed by each party to the other, which is essentially a matter of construing the contract against the facts of the particular transaction.

In the *SEITA* litigation, the lower court observed that no New York court defined the scope of fiduciary duty in the context of currency swaps, but that the Southern District of Ohio, applying New York law, found that counterparties to an interest rate swap transaction were in a business relationship rather than a fiduciary relationship, even though the defendant bank had superior knowledge regarding the swap transactions. See *SEITA*, 1998 N.Y. Misc. 219, at *5-6 (citing *Proctor & Gamble Co. v. Bankers Trust Co.*, 925 F.Supp. 1270 (S.D. Ohio 1996)). The court held that SEITA had not made a showing that its relationship with Salomon Brothers was more extraordinary than that alleged in the *Proctor & Gamble* decision or similar New York cases that rejected claims for breach of fiduciary duty. The court observed that the plaintiff was a large, multibillion dollar corporation which entered into a contractual relationship with the bank as a counterparty and was aware of the substantial risks involved. The plaintiff alleged that the bank served as an investment advisor, but failed to present evidence that such a relationship existed with respect to the currency swap transactions at issue, and failed to submit any agreement for investment advisory services. The Court held that the record underscored that the plaintiff negotiated the terms of the currency swaps with the bank and exercised its independent judgment in deciding to become a counterparty, and the fact that the bank possessed superior

of financial sophistication. Thus, in the case of institutional investors, a dealer must determine its suitability obligations on a transaction-by-transaction basis based on the nature of the particular investor.

knowledge about the swaps did not convert their business relationship into a fiduciary relationship. *Id.* at *6-7. The appellate court expressly rejected the “articulation” of New York law set forth in the *Proctor & Gamble* decision with respect to the notion that a confidential relationship may arise between parties to a business relationship, and agreed with the lower court that the plaintiff’s “subjective claims of reliance on defendant’s expertise” failed to establish a confidential relationship in this case. The Court emphasized that a “high degree” of dominance and reliance must have existed prior to the transaction giving rise to the alleged wrong, and not as a result of it.” See *Societe Nationale D’Exploitation Industrielle des Tabacs et Allumettes v. Salomon Brothers International, Ltd. et al.*, 674 N.Y.S.2d 648, 649 (N.Y.App.Div. 1998).

Regulatory (securities and commodities laws)

Regulatory law can impact in three distinct ways. First, regulatory standards even in “soft law” codes of good conduct can influence courts in their determination of the scope of contractual responsibilities, as in the *Dharmala* case already cited. Second, in certain limited cases concerning private investors, breach of conduct of business rules in the marketing of derivatives products may give rise to a civil right of action. This in fact occurred in the exceptional English case of *Morgan Stanley U.K. Group v Puglisi* [29 January 1998, unreported, Com Ct.]. Third, under U.S. regulatory law, the issue may arise as to whether a particular derivatives product falls within the securities or commodities legislation. The answer has generally been in the negative. See, e.g., *Mount Lucas Associates, Inc. v. MG Refining & Marketing, Inc. et al.*, 682 N.Y.S.2d 14 (N.Y.App.Div. 1998) (holding that energy derivative products were not securities within the U.S. Securities Act of 1933).

An issue under U.S. law presently receiving attention from the OTC derivatives industry, regulators, and Congress is the ultimate enforceability of certain swaps and forward contracts under the Commodity Exchange Act (“CEA”), as amended, and Commodity Futures Trading Commission (“CFTC”) regulations and interpretations thereof. It was recently decided by the federal district court of the Southern District of New York that certain contract(s) there under consideration were arguably unprotected by CFTC exemptive regulations and the *Statutory Interpretation Concerning Forward Transactions*, and could be deemed illegal off-exchange futures contracts under the CEA and therefore unenforceable. The court held that such a determination was necessarily in part a question of fact, and could only be resolved by a jury. See *MG Refining & Marketing, Inc. v. Knight Enterprises, Inc. et al.*, 25 F.Supp.2d 175 (S.D.N.Y. 1998).

Conclusion

A comparative analysis shows that in the main, although the specific methodology differs in detail, the approach of the English and New York courts to those derivatives transactions which have been the subject of decisions is quite similar. It is true to say that the volume of case law is still quite small. It is also correct to say that in neither jurisdiction have the courts recognised derivatives transactions as raising issues different in principle from other contractual disputes. Nevertheless, the clear approach is to uphold transactions and treat complaints by counterparties which have incurred large losses with considerable scepticism. In short, with some notable exceptions, the courts have been inclined to uphold the markets, which has in turn given a solid basis to the choice between English and New York law provided by [for example] ISDA master agreements. The relatively limited litigation experience to date suggests that if anything the English law analysis is the more market-friendly, because of the less complex regulatory

superstructure, and the effective absence of trial by jury in civil cases, though the difference may often be marginal.

3 Verulam Buildings

Gray's Inn, London

5 June 1999

**Challenges for the New International Financial Architecture
Lessons from East Asia
University of Hong Kong
Faculty of Law
June 4-5, 1999**

Derivatives and Emerging Markets

Comment By
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- I. Query: do hedge fund and highly leveraged institution (HLI) OTC derivatives trading activities destabilize [emerging and/or developed] financial markets and, if so, are there available regulatory and/or supervisory solutions?
- II. Operating Premise: The evidence demonstrates that the answer is yes, and that objective solutions may be available. The critical path is to objectively raise and address the real issues in the U.S. and within international forums.
- III. Hedge Funds, HLIs, and Symbiotic Linkages
 - A. Prime brokerage (transactions, commissions and liquidity)
 - B. Raising funds
 - C. Trading strategies
 - D. Sources of information
 - E. Most important linkage: OTC derivatives
- IV. OTC Derivatives Trading and Financial Markets
 - A. Leveraged speculative attacks on Asian equity and currency markets
 - B. Russia banking and currency crisis
 - C. Turbulence in U.S. (and by implication global) financial markets (1998): the “one thousand year storm”

- D. LTCM crisis and Federal Reserve intervention
- V. Range of Regulatory and Supervisory Solutions
 - A. Direct regulation of hedge funds
 - 1. Comprehensive scheme probably impossible, given the offshore argument and political protection already enjoyed by unregulated investment entities
 - 2. LTCM leverage and extent of trading activities was unique among hedge funds (according to “experts”)
 - 3. Regulatory and supervisory reporting and disclosure
 - B. Indirect regulation of hedge funds through enhanced regulation of HLI trading activities (U.S. is the key participant and should facilitate this process)
 - 1. Basle Committee and IOSCO processes are good starting points
See, e.g., Basle Committee on Banking Supervision:
 - a. *Banks’ Interactions With Highly Leveraged Institutions* (January 1999) (appendix 1)
 - b. *Sound Practices for Banks’ Interactions With Highly Leveraged Institutions* (January 1999) (appendix 2)
 - 2. Capital requirements
 - a. Market risk (internal models and value-at-risk)
 - b. Credit risk (Counterparty Risk Management Policy Group and credit risk modeling techniques)
 - 3. Transactional leverage (margin requirements vs reliance on collateral)
 - 4. Accounting requirements (SFAS 133 and IAS 39)
 - 5. Disclosure of trading activities and substantial exposures
 - 6. Enforcement of regulatory and supervisory structures already in place (legislate for consolidated regulation and supervision of unregulated affiliates of broker-dealers)

VI. Conclusions and Observations

Sound Practices for Banks' Interactions with Highly Leveraged Institutions

Basle Committee on Banking Supervision

January 1999

Preface

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VII	Ongoing monitoring of positions vis-à-vis HLIs	13

Preface

In recent years, the activities of highly leveraged institutions (HLIs) have grown in both magnitude and complexity. The scope of the interactions between HLIs and mainstream financial institutions, such as banks and securities firms, has also expanded, emphasising the need for a full understanding and management of the risks generated from these activities. As with other borrowers and counterparties, banks and other financial intermediaries play a key role in allocating credit to HLIs. However, in the case of HLIs this can be particularly challenging given the relative opaqueness of their activities, the significant use of leverage and the dynamic nature of their trading positions and, in some cases, their market impact. The Basle Committee on Banking Supervision recognises that not all banks deal with or have significant exposures to HLIs. Most institutions that do have exposures to HLIs appear to be reviewing and tightening their credit standards for HLIs following the near-collapse of the hedge fund LTCM in September 1998. A key motivation for issuing sound practices is to ensure that improvements in credit standards and risk management processes are “locked in” over time and that the lessons are applied to the management of counterparty credit relationships more generally.

The management of credit risk in respect of HLIs involves the same principles as management of credit risk in general, but must also take account of the particular types of counterparty risk associated with such institutions. The Committee will shortly publish general principles for the management of credit risk. This paper should be seen as complementary to that effort, and is a response to the specific challenges posed by credit risk emanating from interactions with HLIs. The Committee’s review of banks’ dealings with HLIs has revealed that in many cases there has not been an appropriate balance among the key elements of the credit risk management process, with an over reliance on collateralisation of mark-to-market exposures.¹ Insufficient weight was placed on in-depth credit analyses of the HLI counterparties involved and the effective measurement and management of exposures. Moreover, in some cases, competitive forces and the desire to conduct business with certain counterparties may have led banks to make exceptions to their firm-wide credit standards.

Counterparty exposures to HLIs can take a variety of forms, including in particular secured and unsecured credits resulting from off-balance-sheet contracts. The characteristics and implications of OTC derivatives were analysed by G-10 central banks in

1994. Following that review, the Committee issued risk management guidelines for derivatives that identified the types and sources of risk to counterparties in OTC transactions and reviewed sound risk management practices for each type of risk. In September 1998, the Committee on Payment and Settlement Systems and the Euro-currency Standing Committee published a report on settlement procedures and counterparty risk management related to OTC derivatives, which provides a thorough analysis of the policies and procedures employed by OTC derivatives dealers. Where appropriate, these guidelines will draw on these earlier studies and apply them, together with other recent insights, to the specific risks posed by highly leveraged counterparties.

The Basle Committee is distributing these sound practice standards to supervisors, banks and other interested parties worldwide with the expectation that they will encourage the further development of prudent approaches to the assessment, measurement and risk management of credit exposures to HLIs. The Committee invites the financial industry to assess standards and practices and to react to the recommendations. The Committee encourages supervisors to promote the application of sound practices by banks in their interactions with HLIs. The Committee wishes to emphasise that sound internal risk management, including effective counterparty credit risk management, is essential to the prudent operations of banks. With respect to their involvement with HLIs, it may also contribute significantly to ensuring that HLIs do not assume excessive risks and leverage. Should a major HLI nevertheless default, sound risk management at the counterparty level could contribute considerably to limiting the destabilising effects on markets resulting from, for example, the rapid deleveraging and liquidation of positions. By helping to reduce the potential for stressed-market exposures, sound credit management and monitoring practices by counterparties of HLIs should contribute to greater stability in the financial system as a whole.

¹ *Banks' interactions with highly leveraged institutions*, Basle Committee (BIS), January 1999.

I Introduction

This paper sets out sound practice standards for the management of counterparty credit risk inherent in banks' trading and derivatives activities with highly leveraged institutions (HLIs). Its recommendations are directed at relationships with HLIs, which are defined as large financial institutions that are subject to very little or no direct regulatory oversight as well as very limited public disclosure requirements and that take on significant leverage. For the purpose of this paper, leverage is defined broadly as the ratio between risk, expressed in a common denominator, and capital. Leverage increases HLIs' exposure to movements in market prices and consequently can expose creditors to significant counterparty risk. Hedge funds are currently the primary example of institutions within this definition but it should be noted that many hedge funds are not highly leveraged, and that other institutions may also have some or all of the attributes of an HLI.

While this paper focuses on the management of credit risk resulting from interactions with HLIs, the issues raised are not unique to interactions with such institutions. However, it is not intended to provide a complete overview of the more general credit management practices. The sound practices set out here specifically address the following areas: (1) establishing clear policies and procedures for banks' involvement with HLIs as part of their overall credit risk environment; (2) information gathering, due diligence and credit analysis of HLIs' activities, risks and operations; (3) developing more accurate measures of exposures resulting from trading and derivatives transactions; (4) setting meaningful overall credit limits for HLIs; (5) linking credit enhancement tools, including collateral and early termination provisions, to the specific characteristics of HLIs; and (6) closely monitoring credit exposures vis-à-vis HLIs, including their trading activities, risk concentration, leverage and risk management processes.

In Sections II to VII the credit risk management issues highlighted above are set out in more detail.

II Banks' involvement with HLIs and their overall credit risk strategy

Before conducting business with HLIs, a bank should establish clear policies that govern its involvement with these institutions consistent with its overall credit risk strategy. Banks should ensure that an adequate level of risk management, consistent with their involvement with HLIs, is in place.

In general terms, each bank should have in place a clear credit risk strategy and an effective credit risk management process approved by the board of directors and implemented by senior management. The credit risk strategy should define the bank's risk appetite, its desired risk return trade-off and mix of products and markets. In this context, a bank should assess whether dealings with HLIs are consistent with its credit risk strategy, its risk appetite and its diversification targets. If so, policies and procedures for interactions with HLIs must be devised that establish effective monitoring and control of such relationships. These policies and procedures should drive the credit setting process and govern banks' relationships with HLIs, and should not be overridden by competitive pressures.

An effective credit risk management process includes appropriate documentation, comprehensive financial information, effective due diligence, use of risk mitigants such as collateral and covenants, methodologies for measuring current and future exposure, effective limit setting procedures, and ongoing monitoring of both the firm's exposure to and the changing risk profile of the counterparty. Upholding these standards is particularly important with respect to interactions with HLI counterparties, where information has been limited, leverage may be high and risk profiles can alter rapidly. Where credit concerns are identified with regard to an HLI, a bank should either not conduct business or take appropriate steps to limit and manage the exposure consistent with their overall underwriting standards and risk appetite. HLIs that provide either insufficient information to allow meaningful credit assessments or proportionately less information about their risk profile than other counterparties should face tougher credit conditions, including, for instance, a higher level of initial margin, no loss threshold, a narrower range of assets which are deemed acceptable for collateral purposes, and a stricter range of other financial covenants.

The long-term success of a bank's credit relationships relies heavily on effective and sophisticated risk management. This applies to banks that assume credit risks arising out of derivatives and other trading transactions with HLIs such as repurchase agreements and securities lending, as well as to banks that commit funds to HLIs through loans, credit lines or equity participations. Assuming credit exposure implies counterparty monitoring

commensurate with the size of the exposure. Effective monitoring of the activities of an HLI requires thorough knowledge and understanding of its trading strategies, exposure levels, risk concentrations and risk controls. Reliance on collateral cannot substitute for day-to-day risk management and monitoring. While it can help reduce counterparty credit risk, full collateralisation of mark-to-market positions does not eliminate exposure to secondary risks (such as declines in the value of securities pledged as collateral) from a volatile market environment that could follow the default or disorderly liquidation of a major HLI. Moreover, collateral cannot fully mitigate credit risk and may add to other risks, such as legal, operational and liquidity risks.

III Information gathering, due diligence and credit analysis of HLIs

A bank that deals with HLIs should employ sound and well-defined credit standards which address the specific risks associated with HLIs.

An effective credit approval process is the first line of defence against excessive counterparty credit risk. It should be a general requirement but one which assumes increasing importance with the size and/or risk of the counterparty relationship. A sound credit approval process for HLIs should begin with comprehensive financial and other information, providing a clear picture of a counterparty's risk profile and risk management standards. The credit process should identify the purpose and structure of the transactions for which approval is requested and provide a forward-looking analysis of the repayment capacity based on various scenarios. Credit standards should articulate policy regarding the use and nature of collateral arrangements and the application of contractual provisions designed to protect the bank in the event of changes in the future risk profile of the counterparty such as covenants and close-out provisions (Section VI). Moreover, credit standards should set a clear methodology and process for establishing limits (Sections IV and V).

Before entering into any new relationship with an HLI, a bank must become familiar with the counterparty and be confident that it is dealing with an institution of sound repute and creditworthiness. This can be achieved in a number of ways, including asking for references from known parties, accessing credit registers, evaluating legal status, and becoming knowledgeable about the individuals responsible for managing the institution by, for example, checking their personal references and financial state. Banks must also have a clear view about the stability of the HLI, in terms not only of tangible factors such as earnings but also of less tangible ones such as strategy, quality of risk management practices, and staff

composition and turnover. However, a bank should not grant credit solely because the counterparty, or key members of its management, are familiar to the bank or are perceived to be highly reputable.

Before establishing a credit relationship with an HLI, a bank should ensure that all information relevant to that relationship will be available to the bank on a sufficiently timely and ongoing basis. Stipulating the conditions in advance for an adequate transfer of information lays the foundation for an appropriate monitoring of credit risk and for assessing the potential need for adjustments to non-price terms or the application of termination provisions. Banks should seek to obtain information about material developments such as changes in the general direction of trading activities, profit and loss developments, significant changes to leverage, alterations to the risk management procedures or the risk measurement process and changes in key personnel. In order to secure the necessary information, banks must in turn satisfy their HLI counterparties that they have in place effective procedures to ensure the confidentiality of the information obtained through the credit review process.

Banks should obtain comprehensive financial information about an HLI, covering both on and off-balance-sheet positions, to understand the overall risk profile of the institution. Although additional efforts may be necessary to develop effective measures of leverage that relate capital to a common denominator of risk across on and off-balance-sheet positions, a starting point could be some measure of firm-wide value-at-risk (VaR), supplemented with the results of realistic stress testing. It is important that, where this information is used, the bank understand the parameters and the assumptions used in arriving at measures of risk and leverage in order to check the plausibility of the VaR and stress testing results. The bank should establish a clear understanding of the quality and integrity of the HLI's processes and operations for measuring, managing and controlling market, credit and liquidity risks, including back-office systems, accounting and valuation policies and methodologies. The bank should also obtain information about the HLI's liquidity profile, such as committed lines of credit and the availability of liquid, unpledged assets to meet possible increases in margin calls under adverse market conditions. Banks should periodically confirm, in various scenarios, whether the HLI's future repayment capacity is reasonably assured or, for instance, highly dependent on specific assumptions.

Comprehensive and current financial information about an HLI is essential for an effective analysis of the counterparty's credit quality and prudent setting of an internal rating and, consequently, the credit limits granted to the institution and the credit enhancements applied to the relationship. Credit assessment of HLIs and the monitoring and control of the

associated counterparty risks are a more complex and time-consuming activity than credit management in respect of other conventional counterparties. It entails a high level of skill and a willingness to devote resources to regular updating and monitoring, resulting in costs which banks must recognise as part of doing business prudently with such institutions.

IV Exposure measurement

A bank taking on OTC derivatives positions vis-à-vis HLIs should develop meaningful measures of credit exposure and incorporate these measures into its management decision-making process.

Exposure measurement methodologies which provide meaningful information for decision making are an essential underpinning of the credit risk management process for trading and derivatives activities. They form the basis of effective limit setting and monitoring, discussed in Section V. As banks' trading and derivatives activities grow in complexity and as banks move in the direction of relying more on firm-wide credit modelling techniques, it is increasingly important that measures of exposure be based on meaningful methodologies that are subject to continuous improvements commensurate with changing market conditions and practices and the bank's needs. In particular, there are three areas where individual banks and the industry should focus their efforts: (1) the development of more useful measures of potential future exposure (PFE) that provide a meaningful calculation of the overall extent of a bank's activity with a given counterparty; (2) the effective measurement of unsecured exposure inherent in OTC derivatives transactions that are subject to daily margining; and (3) realistic and timely stress testing of counterparty credit exposures.

First, the banking industry must devote further resources to *developing meaningful measures of PFE*. Banks generally measure total exposure to a counterparty as the sum of the current replacement cost (mark-to-market exposure) and PFE. PFE is a measure of how far a contract could move into the money over some defined horizon (typically the life of the contract) and at some specified confidence interval. When added together with the current replacement cost, measures of PFE are used to convert derivatives contracts to "loan equivalent" amounts for aggregating counterparty credit exposures across products and instruments.

Banks must have an effective measure of PFE which gives an accurate picture of the extent of their involvement with the counterparty in relation to their overall activities.

Peak exposure measures should be determined to serve as true loan equivalent measures. PFE should adequately incorporate netting of long and short positions, as well as portfolio effects across products, risk factors and maturities, and be analysed across multiple time horizons. Banks should seek greater industry consensus on the appropriate confidence interval, the volatility concept and calculation period, and the frequency with which volatilities are updated. Banks should also incorporate such improved measures of PFE into their management decision-making process. This would include the ongoing monitoring of mark-to-market exposures against initial estimates of PFE. Banks should use this measure of PFE for assessing whether counterparties' financial capacity is sufficient to meet the level of margin calls implied by their measure of PFE.

Second, banks must *develop more effective measures for assessing the unsecured risks inherent in collateralised derivatives positions*. Such unsecured exposures can take many forms, for example through the use of initial loss thresholds, potential gaps or delays in the collateral/margining process, and the time it takes to liquidate collateral and rebalance positions in the event of counterparty default. Even where OTC derivatives are subject to daily payment and receipt of variation margin (including initial margin), a bank can still face significant unsecured credit exposure under volatile market conditions.

Currently there is no clear industry consensus on how to measure this type of unsecured exposure. Many banks calculate just one measure of PFE, typically over the life of the contract. While such lifetime measures of PFE are appropriate for the purpose of comparing uncollateralised derivatives and loan exposures and measuring overall activity with a given counterparty, they do not provide a meaningful measure of the unsecured credit risk inherent in collateralised derivatives positions. Shorter horizons would be necessary to capture the exposure arising over the time needed to liquidate and rebalance positions and to realise the value of collateral in the event of a failure to meet a margin call or a default by the counterparty. Moreover, shorter horizons will be more appropriate for calibrating initial margins and establishing loss threshold amounts on collateralised derivatives transactions.

Third, banks must develop more meaningful measures of credit risk exposures under volatile market conditions through the *development and implementation of timely and plausible stress tests of counterparty credit exposures*. Stress testing should also evaluate the impact of large market moves on the credit exposure to individual counterparties and the inherent liquidation effects. Stress testing should also consider liquidity impacts on underlying markets and positions and the effect on the value of any pledged collateral. Simply

applying higher confidence intervals or longer time horizons to measures of PFE may not capture the market and exposure dynamics under turbulent market conditions, particularly as they relate to the interaction between market, credit and liquidity risk.

V Limit setting

Effective limit setting depends on the availability of meaningful exposure measurement methodologies. In particular, banks should establish overall credit limits at the level of individual counterparties that aggregate different types of exposures in a comparable and meaningful manner.

Effective measures of PFE are essential for the establishment of meaningful limits, placing an upper bound on the overall scale of activity with, and exposure to, a given counterparty, based on a comparable measure of exposure across a bank's various activities (both on and off-balance-sheet). Mark-to-market exposures should be monitored against initial limits on PFE.

Banks should monitor actual exposures against these initial limits and have in place clear procedures for bringing down exposure as such limits are reached. Moreover, limits should generally be binding and not driven by customer demand. A bank's limit structure should cover the types of exposures discussed in Section IV.

Moreover, banks' credit limits should recognise and reflect the risks associated with the near-term liquidation of derivatives positions in the event of a counterparty default. Where a bank has several transactions with a counterparty, its potential exposure to that counterparty is likely to vary significantly and discontinuously over the maturity over which it is calculated. PFEs should therefore be calculated over multiple time horizons. In the case of collateralised OTC derivatives exposures, limits should factor in the unsecured exposure in a liquidation scenario, that is, the amount that could be lost over the time it takes to rebalance positions and liquidate collateral (net of any initial margin received).

Finally, banks should consider the results of stress testing in the overall limit setting and monitoring process.

VI Collateral, early termination and other contractual provisions

A bank interacting with HLIs should align collateral, early termination and other contractual provisions with the credit quality of HLIs, taking into account the

particular characteristics of these institutions such as their ability to rapidly change trading strategies, risk profiles and leverage. In doing so, banks may be able to control credit risk more pre-emptively than is the case when such provisions are driven solely by net asset values.

Bank policies should determine the contractual provisions that govern HLI counterparty relationships. It is these contractual arrangements, together with the bank's internal limit structure, that should determine the size of unsecured credit exposure assumed by the bank. In a number of market segments the types of collateral arrangements and covenants offered to a counterparty, rather than pricing, constitute the primary means for compensating for risk differentiation. It is therefore paramount that these contractual conditions closely relate to the credit quality of the counterparty.

The use of collateral can significantly reduce counterparty credit risks. Banks use collateral provisions in secured loans, repurchase agreements² and OTC derivatives transactions. This includes transactions for which PFE (Section IV) is highly uncertain and transactions with less creditworthy counterparties. Nonetheless, the use of collateral does not eliminate credit risk and may entail other risks: liquidity, legal, custody and operational risks. Moreover, two-way collateral provisions could give rise to another type of credit risk. A loss could occur, for instance, when the bank has provided collateral owing to a negative exposure and the value of this collateral at the moment of the counterparty's default is larger than the mark-to-market position.

In establishing collateral provisions vis-à-vis HLIs, banks should bear in mind that HLIs are unregulated financial institutions whose leverage is not restricted by the prudential supervision of risk management practices and the capital requirement regimes that apply to regulated financial intermediaries. If a bank does not receive meaningful financial information on a sufficiently frequent basis to permit effective monitoring of counterparty credit risk, it should consider requiring the institution to post excess collateral even when the bank has no current exposure (i.e. posting of initial margin). At a minimum, banks should design and enforce clear internal guidelines for determining when initial margin will be required from counterparties. Similar prudent policies should be established for setting minimum transfer amounts (amounts of collateral below which a counterparty is not required to transfer

² Although different in legal terms, the purchase (sale) of securities in combination with an agreement to reverse the transaction within a specified period amounts to a collateralised transaction in economic terms. In

collateral) and loss thresholds (exposures below which no collateral is posted). Similarly, the granting of two-way margining and rehypothecation rights should be a function of the credit quality of the counterparty. If banks agree to two-way collateral provisions, they should make sure that the resulting additional credit risk exposure is integrated in the overall risk management process (including measurement of the PFE).

Contractual provisions should reflect bank credit standards regarding haircuts applied to the securities taken as collateral, by discounting the collateral value relative to the current market value. Banks usually base the size of the valuation adjustments on the price volatility of the securities over the time that would be required to liquidate them on the default of a counterparty (in normal market conditions). In accepting collateral from HLIs, banks should carefully assess and take into account the correlation between the probability of counterparty default and the likelihood of the collateral being impaired owing to market, credit or liquidity developments. Experience has shown that in stressed-market conditions, all but the most liquid securities issued by the best credits worldwide may be downgraded owing to a broad-based flight to quality following, during or preceding the default of a major HLI.

With respect to OTC derivatives transactions, banks should bear in mind that the effectiveness of collateral provisions established to cover counterparty credit exposures may be significantly reduced if the value of the collateral is negatively correlated with the probability of the counterparty's default or with the market value of the contracts. In stressed-market conditions, sizable amounts of additional collateral may have to be posted by an HLI with a concentrated portfolio. There should be clear documentation setting forth the actions to be taken in the event that a counterparty fails to meet collateral calls.

In addition, banks should include covenants which permit termination or other action in the event of a material deterioration in an HLI's credit quality. The application and design of such early termination or close-out provisions should be a function of the counterparty's credit quality and the ability of the bank to observe changes in (prospective) creditworthiness and to react swiftly to any negative changes. In the case of HLIs, publicly available information may be insufficiently up-to-date to permit continuous credit monitoring. The bank should set adequate standards for information disclosure during the credit relationship and establish termination provisions in relation to the counterparty's risk profile so that it can take risk-reducing measures in a timely manner.

credit risk terms, similar risk management techniques apply to collateralised loans and (reverse) repurchase agreements.

Banks' standard practice in relation to conventional corporate credits is to set a range of covenants relating to financial strength. For HLIs, verifiable covenants addressing significant changes in strategy, or relating to leverage and risk concentration, appear particularly relevant. Reflecting the difficulties of measuring the absolute levels of some of these variables, covenants should be specified in terms of changes to the levels existing at the start of a credit relationship and based on agreed definitions of risk and capital. They should be designed with a view to tightening credit limits as counterparty risk increases. However, banks should realise that industry-wide use of "sudden death" termination provisions could have systemic implications. If these provisions do not affect the extent of risk-taking by HLIs ex ante, the intended credit risk reduction may not materialise, and all lenders may tighten credit terms at the same time. Covenants should ensure that banks are made aware of adverse financial developments and are able to press for adjustment well before the time when cessation of the relationship is appropriate. This pre-emptive aspect is as important as the ability to require repayment once adverse changes have occurred.

VII Ongoing monitoring of positions vis-à-vis HLIs

A bank dealing with HLIs should effectively monitor HLI creditworthiness and the development of its exposure to HLI counterparties. Banks should assess HLI risk profiles and risk management capabilities frequently, while considering the potential for stressed-market conditions.

Given the speed with which HLIs can change their risk profile, banks should conduct reviews of counterparty credit quality of material HLI exposures on a frequent basis, at least quarterly. Additional reviews should be triggered by significant increases in exposure or market volatility. With respect to HLIs, effective monitoring tools should go beyond monthly changes in net asset value and crude balance-sheet measures. There should be detailed quantitative information about risk, for instance VaR numbers supplemented with internal stress testing results. Banks should conduct regular reviews of HLI risk management capabilities. In addition, banks should have a proper understanding of concentrations of risk, including their own exposures to HLIs as a group as well as the risk concentration facing HLIs themselves.

Effective collateral management systems are important for monitoring and limiting counterparty credit exposures. Banks should ensure that collateral management systems capture all counterparty positions, that such positions and related collateral are marked to market on at least a daily basis, and that payment and receipt of (additional) collateral is conducted in a timely manner. Haircuts that apply to the various types of securities that are accepted as collateral should be revised on a regular basis, taking into account price volatility, liquidity and credit quality developments. Where banks focus on limiting credit risk resulting from OTC derivatives positions by timely collateralisation, they should monitor the unsecured part of the exposure (including PFE) particularly closely, taking into account the counterparty's ability to meet future collateral demands. Since OTC derivatives exposures often make up a large part of the total exposure to HLIs, assessing the ability to provide additional collateral when required and setting meaningful credit limits based on such assessments may be especially relevant in dealings with HLIs.

Finally, ongoing exposure monitoring should incorporate the results of periodic stress testing of counterparty credit exposures that takes into account the interaction between market, credit and liquidity risks (Section IV). Such stress testing results should be included in senior management reports and provide sufficient information to trigger risk-reducing actions where necessary.

Banks' Interactions with Highly Leveraged Institutions

Basle Committee on Banking Supervision

January 1999

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**Working Group on Highly Leveraged Institutions
of the Basle Committee on Banking Supervision**

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Executive summary

I. Summary and objectives of the report

In recent years, the activities of highly leveraged institutions (HLIs) have grown in both magnitude and complexity. The scope of the interactions between HLIs and mainstream financial institutions, such as banks and securities firms, has also expanded, underscoring the need for a full understanding and management of the risks generated from these activities – risks both to direct creditors and, under certain market conditions, to the financial system as a whole. However, recent events, most notably the near-collapse of Long-Term Capital Management (LTCM), have highlighted deficiencies in banking institutions' risk management practices with respect to some HLIs. The Committee recognises that banks have the principal responsibility for managing their exposures to these and other counterparties in a safe and prudent manner. However, to the extent that certain activities of HLIs can pose particular risks, not only to direct counterparties but, under certain market conditions, to the financial system as a whole, supervisors should ensure that the proper incentives, procedures and standards are in place to encourage a prudent management of these exposures by banking institutions. The Committee recommends that supervisors consider these issues carefully. Furthermore, given the potential for systemic disruptions, the Committee has also considered the desirability and feasibility of direct regulation of HLIs. However, assessment of the costs, benefits and effectiveness of such direct measures would require a comprehensive review of the potential impact on financial markets and market participants. Moreover, the formulation of any such regulatory approach would clearly extend beyond the competency of bank supervisors and require a political initiative.

This report serves three primary objectives:

Evaluating the potential risks resulting from the activities of HLIs, with particular regard to their interactions with banks.

Assessing the deficiencies in banks' risk management practices in respect of HLIs.

Evaluating alternative policy responses for addressing these risks, including the encouragement of sound practice on the part of banks.

While it is virtually impossible to provide a precise definition of an HLI, for the purpose of this paper the focus will be on large financial institutions that have the following characteristics: (a) they are subject to little or no direct regulatory oversight, as a significant

proportion operate through offshore financial centres; (b) they are subject to limited disclosure requirements; and (c) they take on significant leverage. The Committee recognises that not all so-called hedge funds have these characteristics while many mainstream financial institutions exhibit some of them. As such, the recommendations of the report refer to banks' dealings with institutions that pose the particular counterparty risks arising from such characteristics, however they may be classified.

II. Nature of banks' relationships with HLIs

While the case of LTCM was exceptional in a number of respects, it highlights the nature of the interactions between banks and HLIs, and the associated risks. These risks can be broken down as follows:

In the case of LTCM, by far the largest exposures were those arising from OTC derivatives and repo positions. In these dealings, banks typically transacted on a collateralised basis. Thus, *direct exposures* to LTCM, measured as the replacement value of instruments net of collateral, did not comprise a large percentage of the overall trading and derivatives activities of individual banks.

However, in the event of default or disorderly liquidation, banks may have been further exposed to losses resulting from the liquidation of collateral and the rebalancing of portfolios under adverse market conditions. With regard to LTCM, these potential *secondary exposures* were significant, given the prevalent market volatility and the potential for a major adjustment in prices once the liquidation process commenced. (Nevertheless, the potential losses would have been manageable at the individual counterparty level.) Furthermore, the limited transparency of LTCM prevented creditors from obtaining a complete picture of its investment positions, and consequently limited their ability to gauge such secondary exposures.

The potential for systemic risks following default or disorderly liquidation of an HLI may be based on a number of variables, including the size of the HLI, its leverage, the concentration of its portfolio in particular markets and the prevailing market conditions. Such systemic or *stressed-market exposures* may result from a rapid or disorderly deleveraging of large positions, against the background of already volatile and illiquid markets. This process may lead to higher volatility, the drying-up of liquidity in related markets and subsequent knock-on effects on the portfolios of creditors as well as third parties. Furthermore, the potential increase in risk aversion and uncertainty following such events may contribute to extended distortions in the market.

III. Quality of banks' risk management practices with regard to HLIs

Transactions with HLIs pose particular challenges to the risk management process, given the relative opaqueness of their activities, the absence of a common measure with which to calculate leverage and exposure, and the dynamic nature of their trading strategies. Furthermore, as the case of LTCM highlights, the vulnerability of banking institutions to HLIs may be magnified by the existence of a strong competitive environment in which creditors are tempted to compromise important elements of the risk management process and to agree to generous credit conditions.

Deficiencies in due diligence procedures

Banks generally did not appear to possess effective policies and guidelines for managing exposures to some HLIs in a manner consistent with their overall credit standards. The initial analysis of HLIs' creditworthiness was constrained by the limited availability of financial information; credit decisions were, to some degree, based on non-systematic and largely qualitative assessments of risks, and on the reputation and perceived risk management capabilities of the HLI concerned. These shortcomings appear to have compromised the accuracy and rigour of subsequent stages of the credit process, including the setting of limits and the collateral and margin arrangements.

Other contractual arrangements - such as standard ISDA documentation which specifies acceptable collateral and defines events under which contracts may be closed out - were generally applied. However, certain elements of the close-out clauses - such as limits on deterioration in net asset values - were adjusted to a less prudent level.

Ongoing exposure monitoring

A number of weaknesses were also prevalent in this category. For example, while collateral management systems appeared to adequately measure and provide cover for direct exposures, the Committee did not find a commonly used framework for accurately estimating secondary market exposures. Furthermore, banks did not generally conduct stress tests on their exposure to HLIs.

The frequency as well as the comprehensiveness of counterparty reviews also appeared inadequate in many cases. Annual reviews were typically supplemented by ad hoc updates; banks generally obtained little information on HLIs' off-balance-sheet exposures or risk management strategies.

IV. Potential policy responses

Since certain activities of HLIs can generate significant risks, not only to direct creditors but, under certain circumstances, also to the financial system as a whole, the Committee considered three broad categories of policy responses to address these risks. The first set of responses could be characterised as *indirect* approaches focused on the major counterparties of HLIs (primarily banks and securities houses). The second approach would aim at enhancing the transparency of HLI activities. The third approach would aim directly at and would involve the creation of a framework for the regulation and supervision of such institutions.

Indirect approaches

(a) Promotion of sound practices through the supervisory process

- Many of the risks associated with the activities of HLIs can be addressed through better risk management processes at banks and securities firms. It is important that both banks and supervisors analyse the various risks inherent in transactions involving HLIs and evaluate the deficiencies in existing risk management and controls.
- The committee recommends that supervisors encourage banks to pursue more prudent risk management policies through various means. These include: (a) formulating and implementing standards for sound practices in bank/HLI dealings. A key motivation for articulating such sound practices would be to ensure that improvements seen since the LTCM incident are "locked in" over time; (b) developing a more comprehensive due diligence process, paying

attention to the particular counterparty risks involved in dealings with HLIs; (c) formulating a more consistent process of stress testing; and (d) studying and implementing improved and consistent methodologies for measuring potential future exposure. Progress on this front may also provide the basis for a more effective and consistent setting of limits. A separate sound practices paper which is being released together with this report addresses these issues in more detail.

- The Committee notes that more prudent risk management by banks with respect to their involvement with HLIs could have the additional benefit of limiting or reducing the leverage of these unregulated institutions. This, in turn, may contribute to limiting the riskiness of HLI portfolios and, consequently, to reducing possible third-order or systemic effects resulting from the deleveraging of positions.

(b) Regulatory and supervisory measures

- In addition to promoting sound practices, supervisors may wish to review existing regulatory standards to ensure that these do not provide banks with distorted incentives in dealing with HLIs. The report considers the capital treatment of the credit exposures arising out of derivatives and repurchase transactions with HLIs, as well as the treatment of unsecured lending, lending with inadequate financial covenants and equity participations. A case can be made for strengthening several of these areas. These need to be evaluated in the context of the Basle Committee's overall review of the Capital Accord.
- The Committee also notes that national bank supervisors have a number of instruments at their disposal to influence banks' involvement with HLIs. For instance, in some cases supervisors impose more stringent capital requirements than those of the Basle Accord, or rely on a differentiated supervisory treatment of individual banks (e.g. capital and reporting requirements, large exposure limits) depending on the riskiness of their particular lines of business. In some instances, supervisors may use other formal or informal approaches to prohibit banks from engaging in certain activities, such as lending to a particular class of risky counterparty. Supervisors could therefore evaluate the discretionary instruments available to them to provide proper incentives and disincentives to banks in order to ensure that they deal with HLIs that provide adequate information and do not pose excessive legal or reputational risk. Indirectly, such approaches may have the benefit of stimulating HLIs to manage their risks in a more "responsible" way.

Enhancing transparency

- The Committee recognises the importance of enhanced transparency concerning the activities of HLIs. One possibility would be to conduct a general review of the adequacy of public disclosures provided by global players. Another possibility that has been considered is whether the concept of a credit register for bank loans could be extended to the HLI context. The Basle-based Euro-currency Standing Committee is currently examining a number of options in this area. A number of private sector institutions are also looking at related issues.

Direct approaches

- More direct regulation of HLIs may be necessary should the indirect measures, together with enhanced market transparency, prove to be insufficient. If deemed appropriate, direct regulation could take a number of forms, including licensing requirements, fit and proper tests, and minimum standards for capital and risk management.
- While some of these alternatives hold a certain appeal, there exist a number of key obstacles for these direct approaches. These include (a) arriving at a workable definition of an HLI and (b) establishing jurisdiction over the activities of institutions that are typically located in offshore centres. Overcoming these obstacles would require a high level of political initiative and involve consideration by political, legislative and judiciary bodies.

Introduction

This report, prepared by a small Working Group of the Basle Committee on Banking Supervision*, analyses the risks posed by highly leveraged institutions (HLIs) both to direct creditors and, under certain market conditions, to the financial system as a whole. The report focuses on the interactions between HLIs and mainstream financial players (i.e. banks and securities firms).

Part I of the report provides a description of the characteristics of HLIs and explains the nature of their interactions with banks, using the case of Long-Term Capital Management (LTCM) as an example. Part II assesses the quality of banks' risk management practices with respect to HLIs. Both the credit approval process and ongoing exposure monitoring are examined. Part III discusses possible supervisory and regulatory responses to the weaknesses identified in bank practices and to the overall risks posed by HLIs. In this part, three possible approaches are discussed: (1) promoting sound practices, possibly supplemented through other specific regulatory responses (such as creating proper incentives through capital requirements); (2) enhanced transparency of the activities of large HLIs and possibly other global financial institutions; and (3) direct regulation of HLIs.

The paper accompanying this document presents sound practice standards that address the types of weaknesses identified in banks' dealings with HLI counterparties.

1. Banks' interactions with HLIs and resulting supervisory issues

This section describes banks' involvement with highly leveraged institutions and the potential risks associated with such counterparty relationships. While the discussion focuses on HLIs, some of the observations made apply to banks' credit relationships more generally. The LTCM case is used to illustrate the types of exposures and risks that can arise in connection with counterparty exposures to large HLIs. Such exposures can take many forms, including secured and unsecured credits (both on and off-balance-sheet) and direct investments. As with all counterparty exposures, exposures to HLIs raise safety and soundness issues at the level of individual institutions if they are not managed well. Moreover, in the case of large HLIs such as LTCM, default and rapid liquidation of individual positions could lead to a significant increase in market volatility and a reduction in liquidity, indirectly affecting other financial institutions and potentially the capacity, performance and

* The list of members of the Working Group is included in this report.

stability of markets more generally. The remainder of this section discusses these issues in greater depth.

1.1 Characteristics of HLIs

It is difficult to provide a precise definition of a highly leveraged institution. Rather than attempting to define HLIs in a very specific manner, the Committee was of the opinion that it would be preferable to adopt a broader definition that would also apply to relevant institutions with similar characteristics.

For the purpose of this paper, the focus is on those types of *large* financial institutions that generally have a combination of the following attributes (none of which individually is unique to HLIs). *First*, they are subject to very little or no direct regulatory oversight. In the case of hedge funds, this limited regulatory oversight results from such entities being structured as limited partnerships, investors being either institutions or sophisticated high net worth individuals and the securities issued taking the form of private placements. Moreover, a significant proportion of hedge funds operate through offshore financial centres. *Second*, the HLIs considered in this paper are generally subject to very limited disclosure requirements, compared with regulated financial institutions and/or publicly traded companies, and are not subject to rating by credit-rating agencies. *Third*, such institutions often take on significant leverage, where leverage is the ratio between risk, expressed in some common denominator, and capital. Significant leverage increases HLIs' exposure to large movements in market prices and consequently can expose creditors to significant counterparty risk

Leverage can be achieved through conventional means, such as obtaining cash through unsecured or partially secured debt, but in reality much of the leverage of HLIs is created through the types of trading strategies undertaken and the transaction terms they receive from their counterparties. For example, an HLI effectively leverages its activity when it sells Treasury bonds short and uses the proceeds to establish a long position in corporate bonds against the short position in Treasuries, thus adding basis risk to its position.

Leverage, in itself, is not unique to HLIs. Moreover, leveraged exposures of investors with high-risk appetites can enable a larger number of other investors to reduce their risks. While the leverage that supports the reallocation of risks provides benefits, it can be fragile. In particular, leverage can raise concerns when combined with poor transparency and little or no prudential supervisory oversight as in the case of HLIs. Particularly because of the latter, counterparties must perform the critical role of assessing the leverage employed in the

risk-taking activities of HLIs and of understanding the concentration of positions and trading strategies. For counterparties to fulfil this role, a reasonable degree of transparency is essential. In the absence of public disclosure requirements, such transparency must be achieved through private agreements between HLIs and their counterparties.

Hedge funds are currently the primary example of HLIs, as defined above, though it should be noted that not all of them are highly leveraged (some hedge funds such as LTCM would clearly fall within the HLI definition used) and that HLIs are not necessarily confined to hedge funds. The attraction of such funds for particular types of investors is that they allow them to diversify their portfolio into high-risk investment opportunities. Transactions by hedge funds have also brought additional liquidity to financial markets, at least under normal circumstances.

Hedge funds can be classified into various categories, based primarily on the nature of their trading strategies. But in the broadest sense they can be broken down into two general groups. The first category of institutions comprises macro or directional funds, which take positions based on assumptions about the appropriate level and likely direction of fundamental economic indicators. Such funds are typically active in stock, bond or foreign exchange markets, both cash and derivatives. Many macro/directional funds engage in global trading strategies, with growing emphasis on emerging markets in recent years. Such funds are exposed to outright movements in market prices.

The second group could be characterised as comprising relative value or arbitrage funds. These funds take offsetting positions in comparable financial instruments, betting on changes in their relative value. For example, a fund might take a position based on the spread of a corporate bond narrowing relative to that of a government bond of comparable maturity. Such a position could entail going long on the corporate bond and short on the government bond. Similarly, this type of position could be replicated using derivatives, going long on the swap spread and short on the government futures contract. The larger funds also employ such types of trading strategies across different countries and markets. Relative value funds typically attempt to hedge out exposure to movements in general market risk, but remain exposed to changes in spreads and the liquidity risk associated with the unwinding of the long and short positions of a trade. While these risks are generally seen as smaller than the risks in a set of outright positions in similar instruments and notional amounts, the leverage, size and use of dynamic trading strategies can greatly magnify exposure to the risks of relative value trading, particularly in periods of market stress.

1.2 The case of LTCM

The near-collapse of LTCM highlights certain types of risks that counterparty dealings with HLIs can pose, both for individual institutions and for the financial system more generally. For counterparties, the usual credit risks in transactions were magnified in particular by LTCM's size, its use of extensive leverage, its reliance on a high degree of market liquidity, its concentration in certain markets and instruments, and its highly secretive nature. The combination of these risks may have made LTCM a unique case, but they also raise a number of important issues about the adequacy of counterparties' credit risk management procedures more generally.

Clearly, one of the most noteworthy aspects of the LTCM case relates to the size of its positions, especially taking into account its off-balance-sheet exposures. LTCM is reported to have had a very large number of trades on its books with total assets of \$125 billion. Notional off-balance-sheet positions amounted to well over \$1 trillion, consisting primarily of futures contracts on various exchanges, interest rate swaps and various other types of OTC derivatives positions (although many of the contracts were in fact offsetting).

In addition to sheer size, LTCM appears to have been highly leveraged. LTCM had an equity/balance-sheet asset ratio of about 25 to 1 at the beginning of 1998. This is of course only a very incomplete measure of leverage since it does not account for the impact of LTCM's derivatives portfolio. It is not clear how large LTCM's true leverage was, based on a more meaningful measure that relates capital to some comparable measure of risk for the whole portfolio. (It should be noted that LTCM had also paid back a substantial amount of capital around end-1997 so as to increase gearing in an attempt to enhance the return on capital.)

The question can be posed as to how LTCM managed to become so large and assume so much leverage. With the benefit of hindsight, it is possible to point to a number of factors. First, the lack of transparency made it difficult for individual counterparties to obtain a full picture of LTCM's overall operations and risks. Second, despite this lack of transparency, a strong competitive environment and a strong desire to gain insight into LTCM's trading strategies appear to have led counterparties to compromise important elements of their credit risk management process. Third, some counterparties may have taken excessive comfort by assuming that the relative value strategies of the fund meant that effective leverage was less than that normally implied by the size of the balance sheet and outstanding off-balance-sheet transactions. Fourth, the terms offered by counterparties on margin agreements for repos and OTC derivative instruments – including no initial margin,

two-way margining and other favourable terms – were generous. Fifth, counterparties placed heavy reliance on collateralisation of mark-to-market exposures. And finally, there was an excessive degree of confidence in the reputation and risk management capabilities of LTCM's principals. What cases like LTCM show is that, even when arbitrage or market-neutral strategies are pursued, the large size of positions and the consequent heavy reliance on market liquidity can, in themselves, create substantial risk. These risks include exposure to large margin calls when market volatility increases and the liquidity risk associated with the simultaneous unwinding of large long and short positions.

What also characterised LTCM was the scope of its activities, with involvement in a number of geographic and product markets, in some cases involving quite concentrated positioning within a given instrument class, maturity band or risk factor. LTCM was active in numerous markets, including: (a) government, corporate and emerging market bonds; (b) equities; (c) futures, with positions in over a dozen futures exchanges worldwide (in some cases positions were quite large in relation to total open interest); (d) OTC derivatives, in which it conducted business with about 50 counterparties; and (e) options, with volatility positions in a number of markets, including short volatility positions in equity markets.

A notable feature of LTCM was the extremely secretive nature of its dealings with counterparties and investors. While each counterparty knew its own positions with respect to the fund, none of LTCM's counterparties appear to have had a comprehensive view of its concentrations in particular assets, its major risk positions or its overall risk profile. As a result, it was not possible for counterparties to arrive at meaningful assessments of their true credit exposure.

Contrary to perceptions, LTCM does not, furthermore, appear to have had risk management systems equal to the challenge of its extensive and complicated positions. Moreover, LTCM's models assumed that correlations across major markets and products were relatively low and, consequently, that the portfolio was well diversified. In fact, following the Russian rouble devaluation and debt moratorium, global markets simultaneously moved in the same direction, with credit spreads widening, equity markets declining and volatility increasing in various equity and interest rate markets. The confluence of these events, together with a reduction in liquidity in many markets, ultimately produced the large losses experienced by LTCM.

1.3 Counterparty risks

The LTCM case demonstrates that the activities of large HLIs can result in significant exposures if the counterparty risks are not well managed and understood. At the time of LTCM's near-collapse, the risks to counterparties could be viewed in schematic terms as consisting of three levels: (1) direct exposures; (2) secondary exposures resulting from the potential liquidation of transactions under margining agreements, factoring in volatile markets and higher-than-normal liquidation costs; and (3) stressed-market exposures, factoring in the impact of a potentially broader systemic disturbance on counterparty exposures.

(a) *Direct exposures*

For banks, the most significant exposures to LTCM arose out of their trading and derivatives activities. Banks' direct exposures covered the exposure inherent in the various types of transactions conducted with LTCM. Such exposures arose from OTC derivatives, repurchase agreements, prime brokerage, futures clearing and lending. Moreover, a few banks had equity investments or structured equity-like positions in LTCM.

In the case of OTC derivatives, exposure typically is calculated as the sum of the current mark-to-market exposure, taking into account legally enforceable netting agreements, and potential future exposure (PFE), which provides a measure of how far the contract could move into the money over some defined horizon (typically over the life of the contract) and at some specified confidence interval. When default occurs, the mark-to-market exposure at that time essentially becomes the exposure.

When thinking about the types of exposures arising from LTCM's OTC derivatives transactions, it makes sense to distinguish between collateralised and uncollateralised positions. In the case of LTCM and other HLIs, OTC contracts were conducted primarily on a collateralised basis. Counterparty measurements of current replacement value, net of collateral, generally resulted in minimal exposures. However, as is discussed in more detail below, such a measure of exposure does not capture the potential costs associated with liquidating/replacing positions under adverse market conditions and possible legal obstacles to the liquidation of collateral posted by an insolvent HLI.

For most banks, direct exposures to HLIs, net of collateral, were modest both in absolute terms and as a percentage of overall trading and derivatives activities. Nevertheless, for some, LTCM was among the largest counterparties in a given product category.

(b) Secondary exposures

While counterparties largely dealt on a collateralised basis in their trading and derivatives activities with LTCM (both OTC and exchange-traded derivatives as well as repurchase agreements), there was nevertheless a significant amount of unsecured exposure inherent in these types of transactions. In the event of a default by LTCM (or perhaps even of a disorderly wind-down of its positions), these counterparties would have had to liquidate positions and rebalance their portfolios. Counterparty losses would have been a function of the prices at which such transactions could be executed in relation to those prevailing at the time of the last receipt of collateral. The potential size of such losses depended significantly on the assessment of two factors.

The first relates to the overall market liquidity prevailing at the time of LTCM's near-collapse. There was an overall decline in market liquidity around September 1998, affecting markets in which LTCM was active. As a result of the market turmoil in the summer, a number of large firms had experienced significant trading losses, affecting their willingness to assume relatively risky trading positions. Markets were experiencing a general flight to quality and to liquidity, evidenced by substantial widening of yield spreads on corporate and emerging market bonds. Moreover, implied volatilities in equity indices and interest rates increased substantially over this period. LTCM itself was experiencing difficulties reducing its risk positions, even though it was not attempting to reduce all its positions at the same time.

Second, there was significant uncertainty about the impact on counterparties' direct exposures in the case of a rapid unwinding of LTCM's portfolio against the background of already highly volatile and illiquid market conditions. As mentioned earlier, LTCM's positions were large in absolute terms and, in a number of markets, the large size of LTCM's positions created concentrations. Moreover, LTCM held substantial OTC derivatives positions in instruments for which there was little liquidity, even under normal market conditions. This was due in particular to the long-dated nature of certain types of transactions, the fact that these positions entailed the use of dynamic hedging techniques and the fact that some positions could not be hedged at all.

While it is difficult to fully assess the impact of these various factors, LTCM's major counterparties developed rough estimates of the possible additional losses associated with their direct exposures under such adverse market conditions. In total, these estimates ranged from about \$3 to 5 billion for the institutions participating in the consortium to rescue LTCM.

(c) *Stressed-market exposures*

While counterparties' direct and secondary exposure to losses appeared to be manageable, these could have been magnified by a number of broader risks associated with the default of an HLI the size of LTCM, against the background of the deleveraging and liquidity reduction already in train in the markets since the Russian default. In particular, these include:

- (i) The impact of rapid deleveraging of positions on markets more generally. This could lead to higher volatility and a drying-up of liquidity in related markets beyond those in which LTCM was directly involved.
- (ii) The impact of greater volatility and reduced market liquidity on third parties not directly exposed to LTCM. Moreover, third parties could be destabilised because of rumours about their exposures to LTCM as well as to other HLIs, especially in the absence of clear disclosures.
- (iii) The impact of (i) and (ii) could in turn affect the value of counterparties' other trading positions.
- (iv) A decline in firms' revenues due to overall risk aversion and uncertainty in the markets, resulting in a slowdown in various types of capital market activities (for example, debt and equity underwriting).

These broader, system-wide risks were generally not quantified by institutions in the LTCM context and many, such as the slowdown in revenues, were in evidence even before LTCM's near-collapse. However, some institutions indicated that their measure of potential losses from an LTCM failure could have increased significantly if these broader risks had been included in their measures of exposure.

2. **Quality of banks' risk management practices with regard to HLIs**

Part I used the LTCM case to discuss the different types of risks arising from counterparty dealings with HLIs. This part examines how well banks managed these risks, focusing on two broad areas. The first relates to the credit analysis process, that is, the steps undertaken in the initial assessment of the counterparty's credit quality and the terms under which credit is granted. The second relates to the monitoring and management of exposure after the initial credit-granting process. Collateral arrangement and management processes are considered in the discussion of these two areas.

The Committee recognises that a number of institutions had not dealt with or had significantly restricted their activities with HLI counterparties. The findings discussed below therefore focus on those institutions with a significant exposure to HLIs. It should also be pointed out that not all institutions showed the same shortcomings in their involvement with HLIs as identified below.

Banks and other financial intermediaries have a key role to play in monitoring the risk-taking activities of HLIs and other types of counterparties as part of their credit risk management process. However, in the case of HLIs, this can be particularly challenging, given the relative opaqueness of their activities, the significant use of leverage (which can be difficult to measure) and the dynamic nature of their trading positions.

In fact, banks' risk management processes displayed a number of weaknesses with respect to LTCM and, to some extent, HLIs more broadly. In general, there was a lack of balance between the key elements of the credit risk management process, with a heavy reliance on collateralisation of direct mark-to-market exposures. This in turn made it possible for banks to compromise other critical elements of effective credit risk management, including upfront due diligence, exposure measurement methodologies, the limit setting process, and ongoing monitoring of counterparty exposure, especially concentrations and leverage.

In managing relationships with HLIs, banks clearly relied on significantly less information on the financial strength, condition and liquidity of these counterparties than is common for other types of counterparties. To a significant extent, this compromising of credit standards was the result of a highly competitive market environment and the appetite to conduct business with certain counterparties. Moreover, the quality of credit assessments did not keep pace with the changing risk profile of HLI portfolios (which reflected a general increase in risk through instruments such as complex derivatives and non-dollar repurchase agreements), the implications of rapidly changing market conditions and structural changes in HLI strategies.

2.1 Credit approval process

An effective credit approval process consists of a number of elements, including: (a) sound policies, procedures and documentation; (b) effective upfront analysis of counterparty credit quality; (c) limit setting; (d) establishment of collateral arrangements; and (e) establishment of other contractual provisions. Banks' dealings with HLIs reveal

weaknesses in each of these areas. In many cases, the issues raised here have implications for the credit management process more generally.

(a) Policies, procedures and documentation

Many banks did not have in place effective policies and procedures that provide clear guidelines for managing counterparty credit risk with HLIs consistent with the firm's overall credit standards. In a number of cases, policies tended to be very general, providing inadequate parameters for the types of credit standards to be applied to different classes of counterparty. Moreover, in some cases, the balance between the role of the credit function and that of the business lines appears to have been weighted more heavily towards the latter.

Documentation of initial and ongoing counterparty relationships was poor in many instances, making it very difficult to validate the credit decision-making process and the extent to which credit standards reflected the banks' overall risk appetite. Credit files tended to be more comprehensive at banks that had a more traditional lending franchise than those focusing more heavily on trading and investment banking activities.

(b) Analysis of counterparty credit quality

Upfront analyses of HLI credit quality varied significantly based on the size and reputation of the counterparty. Smaller, more recently established HLIs tended to provide better information than the larger, established ones. Overall, however, counterparty credit assessments can be characterised as highly subjective, relying heavily on qualitative judgement.

Quantitative financial information obtained from LTCM and other large HLIs was relatively limited. Typically, counterparties received monthly information on HLI profitability, expressed in terms of changes in net asset values (NAVs) and adjusted for increases and decreases in capital, unaudited balance-sheet information on a quarterly basis and audited balance sheets on an annual basis. LTCM and other large HLIs did make available to banks some information with which to assess balance-sheet leverage. However, information about off-balance-sheet positions tended to be provided only infrequently (i.e. annually), and it was presented in a relatively aggregated manner, making it difficult to assess the counterparty's risk concentrations in products or markets. Other types of information reviewed included a fund's capital structure and fund offering documents, which discuss issues like redemption procedures and lock-in rules, as well as the types of products that may be traded.

Counterparties received very little financial information to enable them to form a more comprehensive picture of the true risk profile of LTCM and some other HLI counterparties. Nor do counterparties appear in many cases to have required or received risk management reports or other summary measures of market and other risks. In particular, counterparties did not generally receive meaningful information about leverage or the concentration of exposure in certain types of positions, risk factors, trading strategies and risk management capabilities. As a result, counterparties were required to rely largely on qualitative assessments of these risks, typically through meetings and telephone conversations with HLI management and traders. The rigour of the credit review process was therefore largely a function of the willingness of HLI management to provide information.

Based on an assessment of these quantitative and qualitative factors, banks would establish an internal rating for the counterparty. The size of the fund, its track record and the reputation of the principals tended to be associated with higher counterparty credit quality as measured by banks credit-rating systems.

(c) *Limit setting*

The setting of initial limits for HLI counterparties is based on a combination of qualitative and quantitative considerations of the type discussed in (b) above. Thus, the quality of information received has implications for the effectiveness of the limits applied to HLI counterparties. In the case of OTC derivatives, the methodology for specifying limits is generally based on loan equivalent amounts, that is, the sum of current and potential credit exposure, calculated over the life of the contract. As is discussed below, this appears to be an excessively conservative measure that, because it is ignored, can compromise the effectiveness of the limit setting process.

(d) *Collateral arrangements*

While one could observe a loose relationship between the rating of an HLI counterparty and the type of collateral arrangement offered, such arrangements have been, to a significant degree, the result of the interaction of competitive market conditions, internal assessments of counterparty credit quality, and the overall size and reputation of an HLI counterparty.

Many transactions with established HLIs are subject to two-way margining arrangements. Such arrangements may be accompanied by an initial loss threshold amount, which means that collateral must be posted only after exposure has reached a certain level. The major HLIs are not generally required to post initial margin, but may be required to do so

for more exotic transactions. Some established HLIs appear to have negotiated highly favourable terms with credit counterparties, including securities firms and banks.

Lower-rated HLI counterparties may be required to post initial (excess) margin on trading and derivatives activities. Transactions with these counterparties have not generally been subject to a loss threshold amount. In addition, margining arrangements may be on a one-way basis, which means that the HLI will have to post margin for the mark-to-market exposures it creates for the counterparty but not vice versa. However, even collateral arrangements for the lower-rated counterparties appear to have been subject to a significant degree of negotiation and competitive pressure.

Some institutions have developed methodologies for determining the size of initial margins to be applied to lower-rated counterparties. These provide a measure of the volatility inherent in the position to be transacted and are generally expressed as some percentage of the notional amount. Some counterparties calculate measures of potential future exposure using short time horizons. However, in many cases, the ultimate margins applied to lower-rated counterparties have tended to be the outcome of a negotiating process between the bank and the counterparty.

(e) Other contractual provisions

In general, banks apply standard ISDA documentation to their relationships with HLIs, with cross-references to other agreements, for example the PSA for repurchase agreements. In addition to specifying the types of collateral arrangement and acceptable collateral to be delivered, such agreements also define the types of events under which contracts may be closed out. The major close-out provision used in the HLI context is one based on a decline in NAV. While the standard NAV close-out trigger for most HLI counterparties has been a decline in NAV of around 20%, some of the larger HLIs brought competitive pressure to bear and were able to negotiate declines in NAV considerably in excess of this. Of course, this significantly reduces the capital cushion available at the time of a close-out event.

Another problem has been the methodology used to calculate NAV close-out provisions. In some cases, these were calculated using annual returns at either year-end or on a 12-month rolling average basis. Given the potential smoothing of near-term poor performance over a longer time horizon, such a methodology may not be very sensitive to a rapid decline in counterparty credit quality. This problem is magnified when combined with

the 40%-50% close-out triggers that some of the largest counterparties have managed to negotiate.

Beyond NAV thresholds, banks generally did not have flexible contractual provisions that could become more stringent as the credit quality of the counterparty deteriorated. For example, covenants with LTCM did not require the posting of, or increase in, initial margin as the risk profile of the counterparty changed, for instance as leverage increased.

2.2 Ongoing exposure monitoring

Credit assessments of HLIs are likely to have relatively short shelf-lives, owing primarily to the dynamic nature of their business activities. In addition, HLIs are not subject to additional external monitoring on a periodic basis, such as by credit-rating agencies. This raises the importance of ongoing exposure monitoring by the counterparties of HLIs. However, as in the case of the due diligence process, a number of weaknesses have been evident in this practice. These relate in particular to the methodology used to measure exposures, the resulting implications for the limit setting, the frequency and depth with which counterparty reviews are conducted, and the scope and quality of information made available under such reviews.

(a) Exposure measurement methodologies

As discussed earlier, HLI counterparties face various types of exposures, which have been characterised as direct exposures (current replacement cost plus potential future exposure), secondary (close-out and liquidation) exposures and stressed-market exposures.

Direct exposures

Banks generally measure total exposure to a counterparty as the sum of the current mark-to-market exposure and PFE. However, in measuring and managing derivatives activities with LTCM and other HLIs, most banks focused almost exclusively on the timely collateralisation of current mark-to-market values.

Thus, exposures were generally managed on a net-of-collateral basis and not in gross terms, even though the absolute size of positions can present significant risks in itself, as was illustrated by the LTCM experience. Banks looked primarily to their daily collateral management systems as a means to manage and control their exposure.

In general, such collateral management systems have performed well over recent periods of stress, and most banks had their direct exposure secured with cash or marketable securities. This performance of collateral management systems reflected the significant investments made in this area in recent years as well as the automation and centralisation of collateral management functions at many institutions. However, an important challenge for some banks is to ensure that collateral management systems capture all material positions in a timely manner. Moreover, some still do not mark to market all their positions with HLI counterparties on a daily basis.

There would be a clear benefit in the banking industry devoting additional resources to developing more meaningful measures of PFE. Sound measures of PFE are essential for a disciplined process of setting and monitoring overall limits on the size of derivatives activities and exposures with individual counterparties. In particular, it is essential that banks have an effective measure for assessing whether the counterparty's financial capacity is sufficient to meet plausible levels of margin calls, as well as for understanding the full extent of the bank's involvement with the counterparty. This is something which daily marking to market of derivatives exposures cannot provide.

When this concept was developed in the mid-1980s, PFE was frequently measured by the peak exposure of a simulation over some long period, such as five years or the life of the swap, where the peak exposure was defined at a high confidence level such as 95%. While, over time, some banks have introduced refinements to this approach such as simulating the entire portfolio of swaps vis-à-vis a single counterparty and incorporating the effects of legally enforceable netting agreements, the PFE is still seen by some banks to overstate the exposure in OTC derivative contracts. This perception raises the question of whether peak exposure over a long horizon is sufficiently comparable to loan principal amounts to serve as a "loan equivalent" measure. The perception of overstatement of exposure can further be exacerbated by insufficient use of netting, by the failure to effectively capture portfolio effects across products, risk factors and maturities, and by the absence of analysis of PFE at multiple time horizons. In addition, there are major differences across banks in terms of the confidence interval used, the historical period over which volatilities are calculated and the frequency with which such volatilities are updated.

Measures that appear to overestimate exposure, especially when the extent of overestimation is unclear, tend not to be incorporated into the management decision-making process or tend to be used in only a highly judgemental manner. Indeed, relatively few banks appear to monitor their mark-to-market exposures by counterparty against initial estimates of

PFE. The process of establishing and monitoring meaningful limits, especially an upper bound on exposure by counterparty, also appears to be jeopardised by the lack of precision and comparability of exposure measures across a bank's various activities. This is an area requiring further attention by the industry.

Secondary exposures

Even with effective systems for daily collateralisation of mark-to-market exposure, banks can face significant unsecured (or secondary) exposure in their trading and derivatives activities with HLIs, which in the event of default can produce a direct loss, along with the cost of liquidating collateral. Such unsecured exposures can arise in many ways, for example through the use of initial loss thresholds before margin has to be posted, the period it takes to receive margin after a call is made, and the time it takes to liquidate collateral and rebalance collateralised derivatives positions in the event of a counterparty default. Thus, under sufficiently volatile market conditions, even positions subject to initial and daily variation margin requirements can have a high level of inherent unsecured exposure.

Many banks have resorted to the use of loan equivalent PFE measures to assess the risk inherent in their collateralised derivatives transactions. While it is recognised that such calculations are more suitable than those based on a percentage of notional amounts or some other crude measure, they may be less meaningful when trying to quantify exposures highly dependent on margining for repayment. In particular, the use of peak life-time PFE estimates does not in many cases provide a meaningful measure of the possible losses associated with the liquidation and rebalancing of derivatives positions over more relevant, shorter time horizons. Nor may PFEs provide a meaningful tool on the basis of which management can take decisions specifically with respect to setting and monitoring limits on unsecured exposures, calibrating initial margins and setting loss threshold amounts on collateralised derivatives transactions. Greater industry effort is needed to come up with more effective tools for measuring and limiting the unsecured exposure inherent in collateralised derivatives positions.

Stressed-market exposures

This type of exposure can result from any major market disruption, including the impact of the default of a major counterparty on other financial institutions and markets and the feedback effects on an institution's other portfolio positions. To measure these impacts effectively, banks need to conduct a highly sophisticated form of scenario analysis. Probably the only way to truly assess such broader risks is through the use of comprehensive stress

testing, for example evaluating a flight to quality scenario and its impact not only on markets and counterparty credit quality but also on a firm's revenues. Some banks are beginning to explore the joint impact of large market moves, deterioration in credit spreads and a drying-up of liquidity on overall trading positions. Generally, HLI portfolios are subsumed in these broader stress testing exercises. Banks generally did not conduct stress tests on the exposures to major HLI counterparties before the collapse of LTCM.

(b) Monitoring of HLI risk profiles

In many cases, monitoring of HLI counterparty credit quality was conducted as part of the annual credit review process. This was supplemented by monthly analysis of changes in NAVs, quarterly review of unaudited financial statements and annual review of audited financial statements. In the case of LTCM and other HLIs, little information was provided on off-balance-sheet exposures. This relatively limited amount of regular financial information was supplemented through ad hoc qualitative information, typically taking the form of telephone discussions and periodic meetings with the management of HLIs. The information received was generally insufficient to allow banks to assess changes in leverage or the concentration of trading strategies or risk exposures.

In most cases, banks had little insight into the risk management and operational capabilities of HLI counterparties, and this was also the case for LTCM. Most banks did have "checklists" that broadly covered these areas, but in retrospect these proved inadequate. In particular, many banks did not have sufficiently rigorous standards for assessing the quality of HLI risk management methodologies and capabilities relative to their strategies and risk-taking activities. For example, banks did not have a detailed understanding of the types of risk management methodologies employed and the types of parameters and assumptions used (e.g. for VaR calculations). Nor did they have detailed information about the stress testing capabilities of major HLI counterparties. As a result, assessments of risk management were based primarily on qualitative discussions and, in the case of LTCM, largely on the reputation of the principals.

3. Supervisory and regulatory response

As discussed in the previous two parts, certain activities of large HLIs can generate sizable risks, both to counterparties and, under certain market conditions, to the financial system as a whole. In this sense, the overall cost resulting from the failure of a large HLI may not be limited to the private cost of a depreciation of investors' and creditors' assets.

These broader risks cannot be disregarded by supervisors and require careful consideration of the possible policy responses.

Three broad categories of possible policy responses are discussed in this part of the report. The *first* set of responses could be characterised as *indirect* supervisory approaches focused on the major counterparties of HLIs (primarily banks and securities houses). The Basle Committee believes that this is an area where it can take near-term steps to influence the process by which banks manage their HLI relationships, focusing in particular on the articulation of sound practices to the industry and on a review of the incentives created by regulatory capital requirements. Moreover, such indirect measures could go a long way to addressing the various risks to HLI counterparties and the financial system. The *second* set of responses involves enhanced disclosure by global financial institutions, including HLIs. Enhanced market transparency by HLIs and other large financial market participants could be achieved in several ways, a number of which are being reviewed by other international bodies such as the Euro-currency Standing Committee. A *third* set of responses could be aimed *directly* at HLIs through a framework of regulation and supervision of such institutions. Although such direct approaches might have their merit in principle, the Basle Committee is of the view that they may be difficult to implement in practice.

3.1 Indirect supervisory approaches

The Committee believes that many of the risks associated with the activities of large HLIs could be addressed through indirect measures aimed at the counterparties of such institutions (i.e. banks and securities firms). In particular, this could be achieved by addressing some of the weaknesses in these counterparties' management of their credit risk with HLIs. While most counterparties have reviewed and tightened their credit standards for HLIs following the near-collapse of LTCM, a key motivation for articulating sound practices is to ensure that these improvements are "locked in" over the longer term and that the lessons of the HLI experience are applied to the management of counterparty credit relationships more generally.

A key assumption underlying this approach is that, first and foremost, it is the responsibility, indeed it is in the self-interest, of counterparties to manage their risk exposures in a prudent manner. Effective counterparty credit risk management processes at the individual firm level may contribute significantly to ensuring that HLIs do not assume excessive risks and leverage. Should a major HLI default, sound risk management at the counterparty level could contribute considerably to limiting the destabilising effect on

markets, even though there would remain risks of contagion through the indirect impact on markets. In short, sound credit management and monitoring practices by the counterparties of HLIs can help reduce the potential for the types of stressed-market exposures that supervisors and central banks are most concerned about.

In considering regulatory reactions to the risks posed by banks' interactions with HLIs, the Committee recognises the potential role some incentive structures may play in improving the quality of credit management. For example, some supervisors make routine use of variable capital ratios as a supervisory tool, enabling them to adjust required capital holdings in line with perceived risks, many of which may arise from dealings with HLIs. Supervisors can in some instances also use other formal or informal approaches to prohibit banks from engaging in certain activities, including undertaking transactions with particularly risky counterparties, without exercising appropriate controls. This means that, in addition to promoting sound practices and checking on the extent to which they are adhered to, supervisors could in these circumstances use the flexibility already available to provide banks with incentives to deal only with HLIs that provide adequate financial and risk information and that do not pose excessive legal and reputational risks. Such approaches would have the additional benefit of encouraging HLIs to manage their risks in a more effective manner.

(a) Promotion of sound practices at HLI counterparties

The paper accompanying this document presents sound practice standards that address the types of weaknesses identified in banks' dealings with HLI counterparties. In many cases, the issues raised are not unique to HLIs but relate to the credit risk management process more generally. Moreover, it is important that the implementation and monitoring of general sound practice standards be coordinated with securities supervisors, both internationally and domestically. It is primarily the responsibility of individual banks and industry groups to ensure that such practices are fully and meaningfully implemented, including in particular in those areas where further conceptual work is needed, such as the development of more meaningful exposure measurement methodologies. However, where clear deficiencies in risk management practices are identified, these would be corrected through the supervisory and/or examination process (in some countries, examinations are conducted by independent external auditors).

The Committee wishes to highlight the following important areas where practices at many banks need to be enhanced, and which are discussed in greater detail in the sound practices document accompanying this report:

- Establishing clear policies and procedures that define the bank's risk appetite and drive the credit standard setting process.
- Obtaining adequate information from which to make sound judgements of counterparty credit quality.
- Performing adequate due diligence, including setting standards for risk management by counterparties commensurate with the level of sophistication and complexity of their activities.
- Developing more rigorous measures of PFE and using such measures to help set and monitor meaningful overall limits for derivatives counterparties.
- Adequately assessing and measuring unsecured exposure under collateralised derivatives transactions and setting meaningful credit limits based on such assessments.
- Adequately stress testing counterparty credit risk under a variety of scenarios that take into account liquidity effects, with the results incorporated into management decisions about risk taking and limit setting.
- Closely linking non-price terms, including collateral arrangements, covenants (especially regarding leverage) and termination provisions, to assessments of counterparty credit quality.
- Timely monitoring of counterparty transactions and credit exposure, including frequent reassessment of the bank's large exposures, as well as counterparty leverage and the concentration of the counterparty's activities and strategies.

Where credit concerns are identified with regard to a counterparty, or where information on counterparty credit quality is inadequate, a bank should either not conduct business or take appropriate steps to limit and manage the exposure consistent with the firm's overall underwriting standards and risk appetite. If a bank chooses to conduct business on a collateralised basis with counterparties that provide less information about their risk profile, this should be done subject to tougher credit conditions, including, for example, initial margin, no loss threshold, a narrower range of assets deemed acceptable for collateral purposes and a wider range than usual of financial covenants.

(b) *Regulatory responses*

In addition to promoting sound practice through the supervisory process, supervisors should review existing regulatory standards to ensure that these do not provide distorted incentives for banks to engage in risk activities with HLI counterparties. A particularly important area in this regard is the type of incentives created by regulatory capital requirements.

Regulatory capital requirements for HLI exposures

As discussed in Part I, bank exposures to HLIs result largely from OTC derivatives transactions, repurchase agreements, loans and direct equity participations. In each of these cases, there are questions about whether the existing regulatory capital treatment of these positions adequately reflects the risks involved, and whether it results in perverse incentives that fail to encourage banks to take proper account of counterparty risk and leverage.

Issues that might be considered in the review of the Basle Accord include:

- The maximum risk weighting of 50% for non-bank OTC derivatives exposures. Given the expansion in the OTC derivatives markets and the greater range of counterparties now active in them, the general assumption of uniform credit quality that justified a lower weighting ten years ago is unlikely to hold good today.
- The absence of capital charges for possible unsecured exposures resulting from repo transactions. In this context, maximum collateral valuation rules could be established which would reflect the price volatility of underlying securities and the frequency with which positions are marked to market. It would, inter alia, imply the acceptance of OECD government securities against somewhat less than 100% of market value. This would encourage the payment of initial margin on repo transactions to cover potential unsecured exposures arising from adverse market conditions. Furthermore, it would increase the scope for differentiation in the capital treatment of exposures resulting from repo transactions, as any shortfalls from appropriate levels of collateral would be weighted according to counterparty type.
- The adequacy of the 100% risk weightings for HLI counterparties. Exposures to HLIs will often be significantly more risky in view of the shortage of information about these counterparties and where exposures are not accompanied by financial

covenants, in particular where there are no covenants which limit leverage to a prudent level. Possibly all exposures to all counterparties not covered by covenants on leverage should carry a higher weight.

Large exposure measures

The current large exposure rules of member countries are intended to provide only a rough outer limit for credit risk concentrations (for example, the 1991 Basle Committee paper on large exposures recommended limiting exposures to a single counterparty to 25% of capital). Within these broad limits, supervisors expect banks to have in place more refined internal measures of counterparty exposures and limits, and these are subject to review as part of the regular supervisory process. Clearly, events in the second half of 1998 suggest that the leverage and lack of transparency of HLI counterparties represent common risk factors that make such institutions a potential concentration in banks' portfolios. The Committee encourages the industry to continue making progress in developing effective measures of risk concentrations. Increasingly, such measures need to factor in the linkages between adverse market moves and the credit quality of groups of counterparties that may be exposed to common risk factors.

3.2 Enhanced transparency

The Committee recognises the importance of enhanced transparency concerning the activities of HLIs and other large financial institutions with global activities. Indeed, it could be argued that HLI counterparties may not receive sufficient information about HLI risk exposures through the due diligence and exposure monitoring process – even if it were enhanced to allow banks to fully assess and manage their exposure to the types of stressed-market events discussed in Part I – and that additional measures may be necessary to enhance market transparency.

One possibility would be to conduct a general review of the adequacy of public disclosures provided by global players, with an eye to enhancing the type of information that would improve the stability of financial markets. The Euro-currency Standing Committee is at present studying various approaches for enhancing disclosure by financial market participants. This exercise is likely to involve a broader group of market participants than HLIs, and will assess the type of data that could usefully be collected, both with respect to individual market participants and on aggregate market positions.

Another possibility that has been considered is whether the concept of a *credit register* for bank loans could be extended to the HLI context with adequate assurance of confidentiality. The register would entail collecting, in a centralised place, information on the exposures of international financial intermediaries to single counterparties that have the potential to create systemic risk (i.e. major HLIs). Exposures would cover both on and off-balance-sheet positions. Counterparties, supervisors and central banks could then obtain information about the overall indebtedness of the single counterparty.

Such initiatives, if appropriately designed, could contribute to filling information gaps, for both banks and supervisors, in respect of dealings with HLIs. The challenge in all such initiatives would be to ensure that the information was timely and sufficiently meaningful to add value for making assessments about counterparty risk. In particular, there would have to be a clear definition of the types of institutions that would have to report, a universal format for reporting transactions, and clear authority to collect and disseminate the information. In addition, it would be necessary to ascertain whether periodic collection and dissemination of information could provide a meaningful picture of the risk profile of HLIs, which are primarily active in trading and derivatives activities and whose exposures can change daily.

3.3 Direct approaches

The measures discussed in the preceding section are aimed at improving banks' risk management practices with respect to HLIs. Moreover, such improvements should contribute significantly to alleviating potential systemic risks arising from HLI activities. Nevertheless, more direct regulation of HLIs may be necessary should these indirect measures, together with enhanced market transparency, prove to be insufficient.

Consideration of the costs, benefits and effectiveness of such direct measures would require a comprehensive review of the regulatory environment and the potential impact on financial markets and market participants. The formulation of any such regulatory approach would clearly extend beyond the competency of bank supervisors and would require a political initiative. Moreover, direct regulation would require national legislation and/or regulatory changes in the countries where HLIs are based.

If deemed appropriate, direct regulation could take a number of forms, including licensing requirements, fit and proper tests, minimum capital standards, and minimum standards for risk management and control. The regulatory regime would have to focus on the main concern generated by HLI activities, i.e. their potential to generate systemic risk. The

objective of direct regulation would therefore be to avoid an excessive expansion in the size and risk-taking activity of HLIs to a level that might endanger financial stability.

There are, however, a number of critical obstacles to the direct regulation of HLIs. The first relates to the question of how to define an HLI. For the purpose of this report, the Committee has focused on large financial institutions that are subject to little or no regulatory oversight and disclosure requirements, and that take on significant leverage (see Part I). In order to regulate such entities directly, however, a more workable definition will be required. A complicating factor in this respect is that the nature of the activities of an HLI can change significantly over a short period (for instance, the degree of leveraging can increase sharply). Another challenge to this approach is that it is not clear that these institutions would not be able to restructure themselves so that they no longer meet the regulatory definition. While a definition that would place all potential HLIs under regulation would clearly be excessively burdensome, even if it could be made operational, limiting the regulation to those entities that actually engage in the type of activities that give rise to potential systemic risks requires a system of monitoring and policing that would also require considerable effort to maintain.

The second obstacle is that, even if it were possible to arrive at a workable definition of an HLI, it is likely that these institutions would be able to circumvent regulation. Given that the majority of HLIs are registered in offshore centres, any direct regulation would therefore have to extend to these jurisdictions in order to be effective. Such an extension would require a high level of political initiative and would involve consideration by political, legislative and judiciary bodies.

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**Challenges for the New International Financial Architecture
Lessons from East Asia
University of Hong Kong
Faculty of Law
June 4-5, 1999**

**THE CHANGING NATURE OF CONDITIONALITY
AND THE ROLE OF THE IMF**

Comment

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- I. The role of the IMF and its use of conditionality prior to the Mexican crisis of 1994-95
- II. Responses to recent financial crises in emerging market countries
- III. The role of the IMF in the new international financial architecture



A Guide to Progress in Strengthening the Architecture of the International Financial System

Statement by the Managing Director on Progress in Strengthening the Architecture of the International Financial System Executive Board Meeting, April 16, 1999

Experimental Case Studies on Transparency Practices, April 1999

Involving the Private Sector In Forestalling and Resolving Financial Crises, March 1999

News releases on Architecture of the International Financial System

G7 Finance Ministers and Central Bank Governors Declaration and G7 Leaders Statement, October 30, 1998

Memorandum on the Work Program on Strengthening the Architecture of the International Monetary System, October 30, 1998

Reports on International Financial Architecture, October 1998

Report of the Managing Director to the Interim Committee on Progress in Strengthening the Architecture of the International Financial System

April 26, 1999

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Table 1. Progress on Improving the International Architecture

Appendix

Appendix 1. Developing International Standards in Areas Outside the Fund's Direct Operational Current Status

Boxes

1. Strengthening the Special Data Dissemination Standard (SDDS) and Improving Access to External Debt Statistics
2. Enhanced Bank-Fund Financial Sector Collaboration
3. Proposed Ex-ante Measures for Involving the Private Sector
4. Report of the Committee on Monitoring the Private Sector

Report of the Managing Director to the Interim Committee on Progress in Strengthening the Architecture of the International Financial System

I. Overview

1. This report provides an overview of the agenda to strengthen the architecture of the international financial system (Section I); reviews the details of the agenda, by broad topic (Sections II to VI); and includes a matrix indicating the status and next steps for each specific proposal.

2. Developments in the world economy since the Annual Meetings in October 1998 have reconfirmed the importance and urgency of addressing both domestic policy weaknesses and strengthening the architecture of the international financial system. Broad agreement had been reached on a number of the key aspects of the strengthened architecture by October 1998¹, and important reforms have already been introduced. Nevertheless, it remained to refine the general principles and to implement many of the proposals that had been put forward. The Executive Board's work program before the Spring 1999 meetings has been ambitious, and other institutions and fora have also been actively considering various aspects of this complex challenge.

3. Many players—both domestic and international, and both private and official—need to be activated to pursue various aspects of the reforms that, at a general level, command broad support:

- to promote transparency and accountability, and to develop, disseminate and monitor implementation of better standards and best practices;
- to strengthen financial systems, including through better supervision, and appropriate mechanisms for managing bank failures;
- to pay greater attention to the orderly liberalization of capital markets;
- to involve the private sector more fully in forestalling and resolving crises;
- to ensure that systemic issues are adequately addressed, including the appropriate exchange rate regimes and the adequacy of the Fund's resources.

The extent of consensus achieved and progress made in these areas, as well as next steps, are described in the following sections of this report, and in the attached matrix.

4. All of these aspects of a strengthened architecture are interrelated. The development, dissemination, and monitoring of standards is crucial to the strengthening of financial systems; the choice of exchange rate regime and the strengthening of supervisory systems are an integral part of ensuring an orderly process of capital account liberalization; better data, greater transparency of countries' policies and the Fund's assessments of them, as well as strengthened financial systems are critical to reducing the volatility of private sector flows. Similarly, the private sector, national governments and international institutions and fora all need to work together in this endeavor. Private financial institutions and corporations need to adhere to new standards that are being set; national authorities need to ensure that

standards are established and met, that supervisory and regulatory agencies are strengthened, and that vulnerabilities are minimized through better management of macroeconomic and financial policies; and the Fund and other international institutions and fora need to ensure that their efforts are mutually reinforcing and effective.

5. A vital complement to the reform of the financial system will be the strengthening of social policies. Countries need to be better prepared to absorb the impact of the inevitable changes that occur in a dynamic market economy and to allay some of the hardships and maximize the benefits of a global and integrated international financial system. The Fund has been deeply involved with other institutions in establishing social safety nets in recent programs in Asia. However, more needs to be done by the international community, including developing codes of good practices in social policies, where the World Bank is taking the lead,² and in developing social safety nets, before crisis strikes.

6. A strengthened architecture will take time to be put into place and longer to become fully effective. However, this only adds to the urgency with which the international community needs to focus its efforts on translating consensus on principles into operational actions.

II. Transparency, Standards and Surveillance

7. A key pillar in strengthening the architecture of the international financial system relates to enhancing the transparency of the policy process. An element of this involves greater openness on the part of the Fund. The efforts in this area also encompass the private sector as many of the standards (e.g., accounting, auditing, bankruptcy, corporate governance, securities market regulation, etc.) ultimately are implemented at the level of individual firms. While questions remain—such as on the appropriate level of disclosure/regulation of highly leveraged institutions—progress has been achieved on a number of fronts.

Efforts to Improve Transparency and Accountability

8. Better transparency can help foster better economic performance, in part by encouraging more widespread discussion and analysis of a country's policies by the broader community, but also by engendering trust in policy making, which can enable timely and decisive decision making when needed. Similarly, greater transparency on the part of the Fund—greater openness and clarity in its own policies and the advice it provides to countries—can also improve understanding of the Fund's role and operations. Efforts to promote greater transparency on the part of the private sector have focused mainly on the development and implementation of internationally recognized standards.

9. In the past two years, the Executive Board has adopted a series of significant measures to improve transparency of the Fund and its members' policies. Key actions include:

- Development of a policy on release of Public Information Notices (PINs) following Article IV consultations. Members are actively encouraged to consent to their release and PINs are now issued by 70 percent of the Fund's membership.
- Release of documents related to the Debt Initiative for the Heavily Indebted Poor Countries (HIPC), solicitation of public comment on the HIPC Initiative, as well as on the conclusions of the internal and external evaluations of the Fund's Enhanced Structural Adjustment Facility (ESAF). The Fund's preliminary assessment of Fund-supported programs in Asia has also been released to the public.

- Commissioning of external evaluations of the Fund's surveillance and economic research activities—expected to be presented by the summer of 1999.
- Publication of information on the Fund's liquidity position and on member's accounts with the Fund on the Fund's web site.

10. Most recently, the Executive Board has reached important decisions to:

- Establish a presumption that countries would release letters of intent (LOIs), memorandums of economic and financial policies (MEFPs), and policy framework papers (PFPs).
- Release the Chairman's remarks following Executive Board discussions on the use of Fund resources (UFR) by a country.
- Establish an eighteen-month pilot project for the voluntary public release of Article IV staff reports (including combined Article IV and use of Fund resources reports).
- Provide a systematic approach for the public release of PINs following Executive Board discussions of policy papers.
- Further expand public access to the Fund's archives, including a reduction in the waiting period for Executive Board documents from 30 years to 5 years, and for other archived documents to 20 years.

11. In terms of next steps, the Board will:

- Review the experience with the pilot program for release of Article IV reports before the end of the eighteen-month period.³ The issue of PINs for UFR cases and the release of UFR staff reports will be revisited in six months.
- Continue to review experience with Fund-supported programs and Fund surveillance.
- Take stock of the process of external evaluation activities undertaken for the ESAF, Fund surveillance and the Fund's economic research activities with a view to considering proposals on future activities and modalities of external evaluation toward the end of 1999.

The Fund's Progress in Developing Standards

12. Important progress has been made in developing and refining voluntary standards in the areas of direct operational concern to the Fund:

- The Executive Board has agreed to strengthen the *Special Data Dissemination Standard (SDDS)*, notably with respect to international reserves, external debt, and procedures for monitoring observance of the standard (see [Box 1](#)). As of end-March 1999, there were 47 subscribers to the SDDS.
- Work continues on the General Data Dissemination System (GDSS), which is targeted towards those countries not in a position to subscribe to the SDDS.

- A revised draft Manual on fiscal transparency to assist members in implementing the *Code of Good Practices on Fiscal Transparency—Declaration on Principles* has been circulated to the Executive Board for approval by April 23, 1999. The Code, Manual, questionnaire and self-evaluation report are available on Fund's external web site. A dedicated electronic mail box has also been established so country authorities can seek assistance with assessing the transparency of their fiscal management systems and drawing up plans to improve fiscal transparency.
- A draft *Code of Good Practices on Transparency in Monetary and Financial Policies* is well advanced under a project developed by the Fund, working together with the Bank for International Settlements (BIS), a wide range of central banks, other financial supervisory and regulatory agencies, the World Bank, the Organization for Economic Cooperation and Development (OECD), and academics.
- On banking supervision, a draft handbook on the methodology for assessing implementation of the *Basle Core Principles* is being developed by a working group, including the Fund and the World Bank, for early consideration by the Basle Committee on Banking Supervision.

13. Next steps in developing and refining standards include:

- For the SDDS, refined proposals will be drawn up on the transition period for observance of the new prescription on external debt, following further consultation with countries, users, and other international organizations; inclusion of macro-prudential indicators in the SDDS will be examined; the agreed monitoring procedures will be implemented; and prescriptions for the periodicity and timeliness of reserve data dissemination will be re-assessed in the context of the next review of the SDDS, to be conducted around the end of 1999.
- Efforts are underway to encourage all countries to make assessments of fiscal transparency. For those countries where a lack of fiscal transparency affects policy formulation and implementation, national authorities are being encouraged to identify weaknesses and improve their practices, with technical assistance where necessary.
- A progress report on the *Code of Good Practices on Transparency in Monetary and Financial Policies* will be circulated to the Interim Committee. Further work in developing the Code will be undertaken with the expectation that a revised version could be submitted to the Interim Committee for its endorsement at the time of the 1999 Annual Meetings. A supporting paper setting out examples of good practices will be developed to assist members aiming to improve the transparency of their monetary and financial policies.

**Box 1. Strengthening the Special Data Dissemination Standard (SDDS)
and Improving Access to External Debt Statistics**

The Executive Board has strengthened the SDDS. Key decisions include:

- strengthening the prescriptions for the international reserve data category, including dissemination of detailed information on reserve assets and including information on reserve-related liabilities and other potential drains on reserves. Prescribed dissemination of full data corresponding to the new reserve template on a monthly basis, with a lag of no more than one month; data on total reserve assets would still be prescribed for dissemination on a monthly basis with a lag of no more than a week. The dissemination of data for the full template on a weekly basis, with a one week lag, will be encouraged;
- introducing a separate category for external debt, with quarterly disaggregation by sector and maturity. The transition period will be determined after further consultation with countries, users, and international organizations;
- setting a three-year transition period for the dissemination of data on the International Investment Position;
- staff monitoring of observance (on a phased basis) of the data dimension and advance release calendar;
- requiring mandatory hyperlinks between the Fund's Dissemination Standard Bulletin Board (DSBB) and national summary data pages on the Internet, to facilitate monitoring and help meet the needs of data users by the end of 1999; and
- establishing a quarterly certification by subscribers of the accuracy of the metadata on the DSBB.

The *Inter-Agency Task Force on Finance Statistics*, chaired by the Fund, has implemented a joint presentation of external debt statistics from the Bank for International Settlements (BIS), the Organization for Economic Cooperation and Development (OECD), the World Bank, and the Fund to meet the general need for more comprehensive, timely, and accessible data, particularly for shorter maturities. This presentation is now available on the external web sites of these organizations.

The Role of Standards in Fund Surveillance

14. In the context of its surveillance activities, the Fund needs to understand country practices regarding international standards across a range of areas in order to assess vulnerabilities and the implications of particular developments for the effective operation of domestic and international financial systems.

15. Following the discussion in July 1998, the Executive Board recently considered further the role of the Fund in relation to standards. To help illuminate practical considerations involved in monitoring observance of standards, a first round of experimental case studies was prepared.⁴

16. Key areas of emerging consensus within the Executive Board include:

- Standards relevant for the functioning of domestic and international financial systems cover a range of areas, including data dissemination, fiscal, monetary and financial policy transparency, banking regulation and supervision, securities and insurance regulation, accounting, auditing, bankruptcy and corporate governance.
- The official sector can play a useful role in strengthening incentives for adopting standards and help focus efforts to improve transparency. Some form of monitoring of the extent to which countries observe international standards can play a useful role to this end.
- The focus in monitoring observance of standards may need to go beyond disclosure elements of particular standards, and also consider, to the extent feasible, the substance of member's policies relative to the standard.
- For assessments of the observance of standards to be most effective, they need an element of independence.
- Care needs to be taken in the approach to monitoring to ensure that it does not undermine the Fund's traditional role as confidential advisor.

17. The issues and practical modalities in the preparation of "transparency reports"—summarizing the degree to which an economy meets internationally recognized disclosure standards—as recommended by the G-22 and G-7 are complex. The Executive Board agreed that a second round of experimental case studies—covering a wider range of countries, including those where implementation of standards is less advanced—should be undertaken over the next few months to help in developing the Fund's role in this area with a view to having concrete proposals by the 1999 Annual Meetings.

18. A few key issues that need to be considered further are:

- The role of the Fund in monitoring observance of international standards in areas of direct operational (or core) concern. The Fund has expertise that would allow it to assess members' observance of international standards in core areas—data dissemination, transparency of fiscal, monetary and financial policies, and, with other organizations, banking supervision.
- The Fund's involvement with other standards that fall outside its direct operational (non-core) concern and expertise. Other non-core standards—accounting, auditing, bankruptcy, corporate governance, insurance and securities regulation—are also important for the effective operation of financial systems.⁵ Standard-setting bodies in a number of these non-core areas are not likely to be in a position to assess independently the observance of the standards that they have developed. For non-core areas to be monitored, other international financial organizations or group of organizations would need to provide systematic or widespread assessments of these standards.⁶
- Utilizing the expertise of other organizations in particular areas and drawing this work effectively into the Fund's surveillance, in efforts to better identify vulnerabilities.

III. Strengthening Financial Systems

19. The strengthening of financial systems is an essential element of the new architecture. To this end, the Fund, the World Bank, the Basle Committee on Banking Supervision, other key international groupings, and financial supervisors across various regions have stepped up their efforts in developing and disseminating international principles and good practices of sound financial systems. Recent key actions include:

- Review by many *national financial supervisory and regulatory agencies* of their ongoing procedures to enhance oversight of financial sectors in light of recent events, including with respect to highly leveraged institutions.
- The *Basle Committee's* review of gaps in existing work, including on data-related issues, dealing with weak banks, safety nets, licensing, governance and legal and judicial issues; establishment of a task force, including with input from the Fund and World Bank, to review the 1988 Capital Accord; and issuance by a working group of the Basle Committee of reports on standards for banks' interactions with highly leveraged institutions.
- The establishment of the *Financial Stability Forum* to strengthen cooperation among the international organizations, regulatory associations and expert groups with responsibilities in the field of financial regulation and oversight.
- Actions by the *Fund* and the *World Bank* to ensure effective collaboration, particularly as regards the financial sector (see [Box 2](#)).
- Completion by the *International Accounting Standards Committee (IASC)* of its work program in developing a core set of international accounting standards that could be adopted for international cross-border listings.
- Progress by the *OECD* and *World Bank* in finalizing principles of corporate governance (expected by May 1999).

20. Looking ahead, the Fund is strengthening its surveillance of countries' financial systems in the context of Article IV consultations, with a view to improving evaluations of soundness and vulnerabilities, and supporting structural reforms aimed at developing financial sectors. This work will be coordinated with related efforts being carried out in the World Bank, so as to make maximum use of scarce resources while also providing both institutions with a common platform for policy advice, as well as for financial and technical assistance. The intention is to progress in this area by carrying out a number of pilot studies of individual countries in the coming months, and then report to the Executive Board on the experiences gained and to seek Board guidance on next steps. On a related issue, the possible role of peer review in evaluating financial systems needs to be explored further.

21. Efforts to strengthen financial systems will need to continue in various international fora and through implementation by national authorities. One aspect is greater transparency of the private sector, including highly leveraged institutions, which needs to be pursued in the appropriate fora.

22. In addition to the efforts on developing standards and good practices, the legal environment within which financial systems operate needs to be efficient and effective. To this end, several countries have taken welcome actions to improve their bankruptcy laws and procedures, but there is still a need to press ahead more broadly on this front. In this context, the Fund has prepared a report on orderly and effective insolvency procedures, which identifies and discusses key issues that arise for all countries regarding the design and applicability of orderly and effective insolvency procedures. The World Bank also intends to

use this report in its efforts to develop guidelines for effective insolvency regimes for developing countries. In addition, the United Nations Commission on International Trade Law (UNCITRAL)—which has proposed a model law on cross-border insolvency and contributed to the Fund report—has expressed strong interest in collaborating with the Fund and Bank in this area.

Box 2. Enhanced Bank-Fund Financial Sector Collaboration

More effective collaboration between the Fund and the World Bank is important in strengthening financial systems. To this end, the *Financial Sector Liaison Committee* (FSLC) was established in September 1998 to enhance the collaboration process between the two institutions. The aim of this cooperation is to ensure that the Fund and Bank deliver high quality, sound, and timely advice to countries, and that expert staff from both institutions are engaged in the most effective way.

The Committee has:

- initiated actions to enhance coordination of work programs, develop guidelines and procedures for information sharing, and incorporate internationally recognized standards and sound practices in the work program.
- agreed, in principle, to coordinate a joint financial sector monitoring and assessment program aimed at improving evaluations of the health and vulnerabilities on member countries' financial systems.

Next steps on the Committee's agenda include developing further the proposal for collaboration in the form of jointly conducted financial sector assessments that would draw on the resources and feed into the work programs of both institutions.

IV. Capital Account Issues

23. Financial integration, including capital account liberalization, brings substantial benefits. Nevertheless, capital account liberalization carries risks and needs to be carefully managed.

- Capital account liberalization needs to be fully supported by a consistent macroeconomic framework, including monetary and exchange rate policies, and by an adequate institutional set up to strengthen the ability of financial intermediaries and other market participants to manage risk and to support monetary and exchange rate policies.
- Notwithstanding this general principle, countries have followed diverse approaches to the speed and sequencing of capital account liberalization, and views differ on the usefulness and effectiveness of capital controls.

24. Experience from the crises of the last two years has highlighted the following:

- In many cases, poorly sequenced or poorly supported liberalization and inconsistent monetary and exchange rate policies lay behind the accumulation of imbalances that preceded the crisis. Excessive accumulation of short-term debt and highly leveraged positions in the banking and corporate sectors left the economies vulnerable to external shocks or a loss of confidence. Poor

quality risk assessments and herd behavior on the part of investors also contributed to the increased vulnerability.

- Once the crisis began, however, and especially after it intensified following the Russian default, even countries with seemingly appropriate policies were buffeted by volatile international capital markets. Countries that maintained consistent monetary and exchange rate policies, and supported liberalization with financial sector reforms, have been better able to handle capital inflows and subsequent reversals.

25. While supportive of the aim of further liberalization of capital flows, the Executive Board has discussed the use and effectiveness of controls and found it helpful to distinguish between controls over capital outflows and those over inflows.

- Most Directors have concluded that the re-imposition of controls on capital outflows is not an effective policy instrument in a crisis. To be effective for even a short-time, controls need to be wide ranging and strict; yet the more this is the case, the more likely they are to interfere with commercial transactions and debt service and, therefore, to discourage debt rollovers and new inflows. Thus, the resort to controls on outflows is generally seen as likely to increase the severity of the external adjustment and have longer lasting damaging effects on countries' access to international finance. Several Directors, however, considered that, in a crisis, the re-imposition of controls on capital outflows could play a useful role.
- There is much more debate over the effectiveness of disincentives or controls on capital inflows. While the impact of such controls on the total volume of inflows is controversial, there is more support for the view that the composition of inflows shifts toward the longer end of the market. However, countries using controls on inflows have not avoided severe capital flow reversals when policies have been inappropriate—controls on inflows are not a substitute for more fundamental policy action and, when adopted, need to be part of a broader policy package.
- A case can be made that controls on inflows may be justified on prudential grounds in situations of a weak domestic institutional and regulatory environment, and as a means of coping with external market pressures. Nevertheless, it has been emphasized that it is generally preferable to address prudential difficulties directly to avoid the risk to financial systems and the impact of capital controls on the efficient mobilization and allocation of financial resources.

26. In terms of next steps,

- The Fund staff will continue to refine its analysis, and review the experience of countries with the use and effectiveness of specific controls, and experiences with the liberalization of different components of the capital account, seeking to draw conclusions for best practices.
- Further efforts will be made to ensure that Fund surveillance focuses on the appropriate sequencing of capital account liberalization, and that effective safeguards are in place to help ensure the resilience of the economy, particularly the financial sector, to possible shocks.
- Work to improve the reporting and monitoring of capital flows will also continue, including the provision of assistance to countries to improve monitoring of private sector short-term flows, particularly with respect to interbank lines.
- The Executive Board will continue to consider the issue of an amendment to the Articles of

Agreement to address liberalization of capital movements, taking account of the recent experience.

V. Involving the Private Sector in Forestalling and Resolving Crises

27. The effort to better involve the private sector in crisis resolution seeks to bring about a more orderly adjustment process; limit moral hazard and strengthen market discipline; and help emerging market borrowers protect themselves against volatility and contagion. Looking at the experience of the past two years, the case-by-case approach has achieved a degree of success.

- In large part, the approach in Brazil, Indonesia, Korea, and Thailand has relied on a combination of strengthened economic policies, official financing and varying approaches to the private sector. In addition, in the cases of Korea, Indonesia, and Ukraine, moral suasion by the international community or Fund involvement in negotiations has assisted in securing continued private sector financing in support of countries' adjustment programs. In the case of Brazil, voluntary agreement has been reached with commercial bank creditors to maintain their exposure.
- As a result of such cooperative efforts, exposures have been maintained and some burden sharing achieved, but not without difficulty and concern about the systemic implications for future operations.

28. However, it is generally agreed that more needs to be done to create market-based incentives and instruments for the private sector to remain involved. While a diversity of views has been expressed, some progress has been made and a consensus appears to be emerging in a number of areas.

Intensify Efforts at Preventing Crises

29. Prevention remains the key and is the primary responsibility of individual members working in collaboration with the Fund and the international community more generally. Countries' efforts should be aimed at improving both their macroeconomic and structural policies, and the environment for private sector risk assessment and decision making by improving the flow of information and the regulatory environment, and limiting implicit and explicit guarantees to the private sector. Key elements are:

- Countries should maintain an appropriate debt profile, by avoiding the excessive accumulation of short-term debt or an excessively rigid debt structure, and by ensuring adequate levels of both official reserves and banking system liquidity to help provide for orderly handling of a temporary reduction in capital market access. Countries should establish or strengthen systems for the high-frequency monitoring of private external liabilities, to better monitor short-term capital flows, and to provide early warnings of emerging difficulties. The Fund staff is providing assistance to a number of countries in developing and strengthening monitoring systems.
- Countries should exercise appropriate restraint with respect to the official sector's off-balance sheet transactions and ensuring that the supervisory authorities take account of financial entities' vulnerability to financial derivatives. Limiting the use of put options in sovereign debt instruments, and ensuring that appropriate action is taken in the context of supervision of banks' exposure to such instruments, should reduce the likelihood and/or the severity of financial crises. The Fund staff will give more attention to potential vulnerabilities associated with debt structures and financial derivatives in the context of both surveillance and the use of Fund resources.
- Effective communication between emerging market borrowers and private capital markets should

be maintained. Such contacts have proved their worth during periods of market stress in Latin America. The Fund should consider ways it could assist member countries in establishing regular communication with their creditors, including giving further consideration to the creation of creditor-debtor councils, with due attention to potential problems such as those of insider information. The Fund is also seeking to expand its regular contacts with markets.

Implementing Measures to Facilitate the Private Sector's Involvement

30. Prevention needs to be buttressed by measures designed and adapted ex ante to better ensure the involvement of the private sector in crisis avoidance or orderly resolution. Such measures, designed and put in place before the event, could help facilitate the orderly resolution of balance of payments pressures. These include mechanisms that effectively pre-commit private sector participants to maintain or provide additional net exposure, or reduce debt-service burdens, in times of crisis, while limiting moral hazard and the distortion to markets in normal times. Mechanisms are also needed for dealing with extreme situations when ex ante measures do not deliver the needed support and it is not possible to reach agreement on an orderly refinancing or debt restructuring. In considering options, two key principles are:

- Contracts should be honored. It is important for the efficient operation of markets that proposals to permit the modification of contracts ensure that both lenders and borrowers understand the rules of the system and abide by them and that in extreme circumstances cooperative solutions be sought to countries' financing problems.
- Care is required to ensure that solutions adopted to help avoid or resolve a crisis in one case do not have broader adverse effects that could potentially cause more difficulties than they solve.

31. In addition to proposals that would seek to reduce any bias that might exist in the short-term interbank credit markets, and to modify the terms of bond contracts, several measures have been proposed (see [Box 3](#)). While there is clearly a need to make progress in some areas, all of the proposals involve potential drawbacks or trade-offs that need to be borne in mind.

32. There are three areas where agreement seems to be emerging:

- **Re-assess capital standards by the Basle Committee** to include measures to reduce the perceived bias toward short-term interbank credit lines from industrial countries to emerging market banks. The Basle Committee on Banking Supervision (BCBS) is engaged in a re-assessment of the Basle Capital Accord.
- **Move forward with modification of bond contracts.** This could be done through inclusion of sharing clauses, provisions for the modification of terms by qualified majorities, and collective representation provisions, or other modifications to achieve the same objectives. British-style Trust Deed bonds contain such clauses and could serve as a useful model for future issues; but it is not the only model. While consideration is being given to this issue in other fora, little progress has occurred. This suggests that some form of concerted action by major industrial countries to encourage emerging market borrowers to modify the terms of their new issues may be required. Another approach would be to rely upon a demonstration effect, through the inclusion of the new contractual terms in international bond issues by G-10 sovereigns. This would seek to establish the new instrument as an industry standard and could reduce the costs associated with their use.

Consideration should also be given to a coordinated regulatory requirement for new sovereign

issues admitted to domestic markets to meet specified minimum conditions regarding contractual provisions. A concerted regulatory approach, intended to reflect systemic concerns, may go beyond the traditional role of security market regulators to protect investors. For its part, the Fund would encourage members to include terms that would facilitate restructuring in bond issues. These steps could be complemented by efforts to build a consensus in support of these changes among the financial institutions involved in issuing and underwriting sovereign bonds.

- **Contingent financing and debt service insurance.** Borrowers should explore with their creditors possibilities for private contingent credit lines and other debt instruments that provide additional liquidity, or reduce debt-service burdens, in periods of severe balance of payments difficulties.

Box 3. Proposed Ex-ante Measures for Involving the Private Sector

Private Contingent Credit Lines that could be drawn on in times of difficulty, if fairly priced, could provide efficient insurance against adverse market developments, including liquidity risk, and could contribute to effective burden sharing during periods of stress. At the same time, in complex financial markets, hedging strategies of private financial institutions could lead to offsetting transactions with the country concerned and/or shift pressures to other markets. Members should be encouraged to explore contingent credit lines with private financial institutions.

Call Options in Interbank Credit Lines could provide a contractual basis for an extension of maturities under specified conditions. However, interbank credit lines often are a key source of short-term liquidity for countries, and the triggering of such options could lead to a loss of maturing short-term credit lines in advance of a call, thereby exacerbating liquidity difficulties.

Debt Service Insurance, including structured notes, that generates a debt service burden that varies counter-cyclically against overall economic developments of the country could help reduce risk of crisis. Such instruments are more likely to be feasible for members that have highly concentrated exports (such as many oil or primary commodities exporters), where contracts can be linked mainly to exogenous developments.

Official guarantees of new debt through full or partial guarantees of new sovereign or private debt instruments may hold promise at times when market access is very limited, for example during the emergence from a crisis. However, questions can be raised about the effectiveness of guarantees. The World Bank has recently reviewed its experience with guarantees and has proposed a limited policy-based guarantee program. An assessment of the experience with this program will be conducted at an appropriate point.

33. In extreme situations, if ex ante mechanisms put in place fail to deliver the needed support in sufficient amounts and/or efforts to reach agreement on voluntary debt restructuring fail and pressures in the external accounts do not abate, members may be faced with a need to consider some combination of a default on sovereign bonds and the imposition of exchange controls. Such measures could lead to an interruption in the ability of nonsovereigns to service their external debts. There is little modern experience with restructuring sovereign bonds or with renegotiating private debt caught up in exchange

controls, and so it is difficult to predict how the process would unfold. To permit the Fund to support a member's adjustment policies during the possibly protracted period of debt negotiations that could follow such action, the Fund's financing assurances and arrears policies have been modified so as to permit, on a case-by-case basis, the Fund to lend into arrears. Certain issues remain to be resolved regarding the conditions under which the Fund would proceed, and the Board will return to this at an early date. Other measures to involve the private sector in extreme circumstances are discussed in Box 4.

34. There also is a need to explore ways to ensure that in extreme situations, the process of debt negotiation following default, even if protracted, remains orderly. Some consider that there is little danger of creditors resorting to disruptive litigation on a scale that could effectively disrupt a country's adjustment efforts or the capacity of the Fund to support those efforts. Others, however, consider that there is a possibility that creditor litigation could block progress toward an orderly debt restructuring and challenge the Fund's ability to provide effective support for a member's adjustment efforts. Against this background, further consideration could be given to the possibility of adopting some mechanism to allow the official community to endorse a temporary stay on creditor litigation, possibly through an amendment of Article VIII, Section 2(b) of the Fund's Articles of Agreement.

Box 4. Proposed Extreme Measures for Involving the Private Sector

Concerted Rollovers of External Debt, in the case of Korea, against the background of a hemorrhaging of official reserves and the prospect of an imminent default, were successful in stabilizing a critical situation and facilitating a restructuring of interbank claims into sovereign guaranteed bonds. However, Korea's success reflected some special circumstances, and could be difficult to replicate in other cases. In deciding on such operations, the international community must pay special care to the danger that concerted operations in one case could lead creditors to withdraw credit lines in advance of a crisis elsewhere for fear of a concerted rollover.

Restructuring International Sovereign Bonds raises difficult issues, which would need to be considered on a case-by-case basis. In practice, there is a trade-off between the immediate cash flow relief associated with bond restructuring and the resulting reduction over the medium term in the country's ability to mobilize resources from private creditors.

VI. Systemic Issues

35. In strengthening the architecture of the international financial system, the Executive Board has directed efforts on a number of systemic aspects.

Implications of Capital-Mobility and Exchange-Rate Volatility

36. The profound changes that the international monetary and financial system has undergone in postwar period, in particular over the last two decades, raise broad systemic issues. In the preliminary discussion on Fund-supported programs in East Asia, a lesson drawn was that the stable exchange rates of the countries affected may have led borrowers and creditors alike largely to disregard currency risks, perceiving that they were implicitly guaranteed against related losses. However, adoption of a more flexible exchange rate regime is no panacea and, regardless of the regime, vulnerabilities would continue to exist and standards for strengthened financial systems and improvements in transparency would still

be required.

37. Before the 1999 Annual Meetings, the Board will hold a seminar to address these issues. In the area of exchange-rate regimes, the focus will be on the volatility of the exchange value of major currencies, the scope for measures to moderate such volatility, and the consequences for the exchange-rate policy of emerging market economies. As for asset markets, the focus will be on the systemic aspects of major swings in capital flows to developing countries and on possible general, systemic, measures to moderate the boom phase of the cycle on the side of lenders as well as of borrowers, including some of those addressed above for strengthening financial systems, and improving transparency and accountability.

Developing the Fund's Facilities

38. Progress is being made in adapting the Fund's facilities to the new international architecture. A review of the Supplemental Reserve Facility (SRF) was conducted in January 1999 with an eye to ensuring that the Fund is ready to respond promptly and effectively to member's need for balance of payments financing.

39. At the same time, ways have been explored in which the Fund could support members whose economies are fundamentally sound and well managed, but which are concerned with the potential effects of contagion on their access to capital markets. In this regard, the Board has created a contingent credit line (CCL) in the Fund. This new facility is intended to play an important role in preventing crises, including by creating further incentives for the adoption of strong policies and adherence to internationally recognized standards, encouraging the constructive involvement of the private sector, and thereby reducing the risks of financial market contagion.

Strengthening the Fund's Resources

40. In order to effectively play its role in safeguarding the stability of the international monetary system, the Fund needs sufficient financial resources. To that end, important actions have been taken.

- The New Arrangements to Borrow (NAB) came into force on November 17, 1998. The total amount of resources available to the IMF under the NAB and General Arrangements to Borrow (GAB) combined will be up to SDR 34 billion (about US\$46 billion), double the amount under the GAB alone.
- The IMF quota increase under the Eleventh General Review of Quotas came into effect on January 22, 1999, raising overall quotas from SDR 146 billion (about US\$200 billion) to SDR 212 billion (about US\$290 billion). The increase in usable quota resources enabled repayment of amounts borrowed earlier from the GAB and NAB. At end-March 1999, the Fund's liquidity ratio stood at close to 90 percent compared to below 30 percent in late 1998.

41. Beyond these actions, a special SDR allocation has been proposed, through an amendment in the Articles of Agreement, and is in the process of ratification by the Fund's membership. However, securing full financing for the ESAF and the Fund's participation in the HIPC Initiative remains a major challenge, and further efforts are urgently needed to ensure that the Fund has sufficient resources to support the structural adjustment programs of the poorest countries and to provide agreed debt relief.

Table 1. Progress on Improving the International Architecture

Proposal	Action Required	Executive Board's View	Progress to Date	Next Steps
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I. Transparency, Standards, and Surveillance				
A. Transparency and accountability				
(i) Official sector				
<p>Press Information Notices (PINs). Agreement to continue to actively encourage the release of PINs following Article IV consultations and extension of their use to policy papers.</p>	<p>(i) Decision by members to release PINs following Article IV Consultations.</p> <p>(ii) Executive Board decision on procedures for the release of PINs following discussions of policy papers.</p>	<p>Board endorsed both staff proposals.</p>	<p>PINs were released for 70 percent of Article IV Consultations from August-December 1998. Lags shortened, and number of modifications reduced.</p> <p>First policy PIN was released 3/29/99 for discussion of SDDS reserves data.</p>	<p>National authorities are actively encouraged to allow release of PINs following Article IV consultations.</p> <p>Fund staff to develop internal guidelines for release of PINs on policy papers shortly.</p> <p>Fund Board's next review of PIN policy planned for April 2000 (PINs in UFR cases discussed below).</p>
<p>Article IV staff reports. Allow voluntary release of reports.</p>	<p>Executive Board decision.</p>	<p>Majority in favor but views differed widely.</p>	<p>On 4/5/99, authorization of an eighteen-month pilot program for the <i>voluntary</i> release of Article IV reports.</p>	<p>National authorities to volunteer for pilot program.</p> <p>Fund staff to proceed expeditiously to put in place the modalities for the evaluation of the pilot, drawing on outside consultants supplemented by external review.</p> <p>Fund Board to make new policy known to constituencies.</p>
<p>UFR. (i) Publication of Chairman's remarks on programs, and voluntary release of summings up following Board discussion; (ii) strongly encourage publication of LOIs/MEFPs and PFPs, particularly in cases that require continued access to private markets; and (iii) voluntary release of staff reports for UFR.</p>	<p>Executive Board decision.</p>	<p>Agreed on:</p> <p>(i) establishment of a presumption that LOIs/MEFPs and PFPs would be released, subject to a review after one year; and</p> <p>(ii) proceeding with the release of the Chairman's remarks in UFR cases, on understanding that the question of UFR PINs and release of UFR staff reports would be revisited in six months.</p>	<p>Implemented.</p>	<p>Fund staff to advise members on new policy.</p> <p>Fund Board to make new policy known to constituencies. Board to review further policies after one year. In addition, issues may be reviewed in light of the experience gained in transparency in other areas.</p> <p>National authorities are presumed to release LOIs/MEFPs and PFPs.</p>

Access to Fund's archives. Allow accelerated public access to the Fund's archives.	Executive Board decision to shorten time limits from 30 years to 5 years for access to Board documents; and to 20 years for other archival documents.	Board approved proposals, with a transition period of six months before new policy goes into effect.	Implemented.	Fund Board to review policy in two years, with view to possible further liberalization.
Data provision to the Fund. Reach agreement on minimum standard for reporting of reserves and related items.	Agreement on minimum standard.	Most Directors were supportive of principle, but had differing views on content, reporting frequency, and lags.	Proposals will be based on Board decisions regarding reserves in the SDDS (see SDDS).	Fund staff to bring proposals to IMF Board after Interim Committee, based on SDDS decisions reached at 3/23/99 Board meeting.
Enhanced evaluation of the Fund's activities.	Systematic evaluation of Fund activities.	Diverse views. Directors have agreed to take stock, following completion of current program of external reviews.	Internal and External evaluations of ESAF (published) Fund's preliminary assessment of Fund-supported programs in Asia (published) External evaluation of Fund surveillance and the Fund's economic research activities under way (results expected to be presented by the summer of 1999)	Fund Board to take stock of evaluation process, following completion of current program of external review, toward the end of 1999.
<i>(ii) Private sector</i>				
Private Sector Disclosure.	Assess how operations of key financial market participants could be improved through greater disclosure requirements.	There are important gaps in this area.	Widening coverage of BIS data to other emerging markets and, especially, off-shore financial centers. Continuing progress linked to actions on standards.	National authorities and standard-setting bodies (BCBS, CGFS, IAIS, IASC, and IOSCO) to pursue ongoing work. Financial Stability Forum to prepare a report on offshore centers in next six months.
Highly Leveraged Institutions.	Assess appropriate supervisory/regulatory structure and disclosure to markets.	Most Directors saw this as a particularly important area for improved supervision/regulation, but recognized difficulties with design and measurement.	Reports by BCBS and IOSCO (Feb 1999), on standards for bank's financial relations with highly leveraged institutions.	National authorities and standard-setting bodies to further develop and implement standards for banks' relations with highly leveraged institutions. Consideration of public data disclosure requirements for highly leveraged institutions.

				Financial Stability Forum to prepare a report on HLIs in next six months.
B. Standards				
SDDS. Strengthening data dissemination on reserves and external debt.	Strengthen the SDDS prescriptions for: (i) international reserves and related items; (ii) external debt and debt service. Consider inclusion of macro-prudential indicators of vulnerability in the SDDS.	Supportive; concerns from some Directors about degree of detail, costs of compliance, and lack of symmetry in publication of data by private sector.	The Board has agreed to strengthen the SDDS prescriptions in the areas of debt (12/98) and international reserves (3/99). Also established procedures for monitoring observance of the standard.	<p>National authorities that have subscribed to the SDDS to comply with existing standards; by <i>March 31, 2000</i> to observe revised standards for reserves. Others to consider subscribing to the SDDS and take necessary steps.</p> <p>Fund staff to establish monitoring procedures; to consult with compilers on debt transition period (will report to Board by end of 1999); and to collaborate with BCBS to come up on agreed set of macro-prudential indicators. Draft operational guidelines on international reserves data to be prepared by June 1999.</p> <p>International organizations to participate in consultation processes and provide feedback. CGFS to collaborate in preparation of operational guidelines.</p>
Code of Good Practices on Fiscal Transparency. Implement code endorsed by Interim Committee in April 1998.	Endorsement of manual by IMF Executive Board.	Supportive.	Revised draft manual on fiscal transparency issued to Board on lapse of time basis. Code, manual and questionnaire were posted on the external web site in November 1998.	<p>National authorities to aim at adhering to Code.</p> <p>Fund staff working on pilot assessments of fiscal transparency.</p>

Code of Good Practices on Transparency in Monetary and Financial Policies.	Approval of code.	Broad agreement on principles.	Board seminar on March 19, and meeting with financial supervisory and regulatory experts on March 22. Revised draft discussed at April 9 Fund Board meeting.	Revised draft of code to be circulated to Interim Committee. Fund Board to consider soon after IC meeting.
Banking supervision. Address gaps in existing standards; identify areas where further work could help countries achieve compliance with the <i>Basle Core Principles</i> ; and review 1988 Capital Accord.	Review gaps in existing standards; develop a handbook on the methodology for assessing implementation of the <i>Basle Core Principles</i> , and consider updating Capital Accord.	Supportive.	Basle Committee reviewing gaps. Draft handbook prepared by the Liaison Group (includes G-10 and non G-10 countries), in consultation with the Fund and World Bank, to be considered by Basle Committee in April 1999. BCBS Task Force established to review Capital Accord.	Basle Committee to finalize handbook. Fund and World Bank staff are likely to be the main agencies responsible for assessing compliance with <i>Core Principles</i> . Task force will aim to have concrete proposals on fast-track to improve capital accord by December 1999.
Other standards. Relevant standard-setting bodies to complete work on developing other standards relevant for the functioning of financial systems.	Continue developing standards in following areas: accounting and auditing, bankruptcy, corporate governance, insurance regulation, payment and settlement systems, and securities market regulation.	Supportive.	Ongoing. (See <u>appendix I</u> for an update of the current status of progress in individual areas).	Relevant standard-setting bodies to continue work.
c. Surveillance				
Fund Surveillance and International Standards. Fund to better integrate use of standards in surveillance. G-22/G-7 go further and recommend that the Fund publish transparency reports.	IMF Board to consider Fund's role, including in preparation and publication of transparency reports.	Supportive of staff's initial experimental studies; encouraged staff to proceed with assessment of what is feasible and to develop specific proposals for extending work.	Experimental case studies have been prepared for Argentina, Australia, and the United Kingdom, and one has been commenced for Hong Kong SAR.	Fund staff to prepare a second round of case studies and to initiate outreach program to solicit reactions to initial studies. Studies will be made available on Fund's web site. Concrete proposals to Fund Board before 1999 Annual Meeting.

<p>Comprehensive reporting on the capital account. Develop mechanisms for better assessing capital flows and external vulnerability.</p> <p>Improve member's systems for monitoring of short-term external debt, in order to improve surveillance and help forestall financial crisis.</p>	<p>Strengthened surveillance over debt and capital flows; improved databases of creditor information on debt; improving data systems and reporting by members on debt/capital flows.</p> <p>Implement or strengthen high-frequency monitoring system for short-term capital flows, particularly interbank lines from foreign banks.</p>	<p>Board endorsed these efforts.</p>	<p><i>Within the Fund:</i> Staff has expanded reporting to Board through WEMD, reports on financial market developments, and through published reports on international capital market developments; interdepartmental task force led efforts to improve creditor data (BIS, OECD) and facilitate access. Enhanced creditor-side data on external debt and internal system for disseminating detailed BIS data came on line on Internet in March.</p> <p><i>Technical assistance:</i> continued efforts within Fund to provide assistance, disseminate best practice. TA to members in improving data and monitoring systems.</p>	<p>Fund staff to continue work to implement detailed recommendations of task force.</p> <p>National authorities. Efforts to strengthen data systems on external debt and reserves and further public dissemination (see SDDS).</p> <p>International organizations. BIS, IMF, OECD, and World Bank to collaborate on IATF to widen coverage of creditor data systems, shorten publication lags.</p> <p>Financial Stability Forum to prepare a report on short-term capital flows in next six months.</p>
<p>Early Warning Systems. Develop and test empirical models to help predict balance of payments crises.</p>	<p>Develop, for use within the Fund, prototype operational models to predict crises.</p>	<p>Saw merit in continued research in this area; cautious about reliance as predictor of crisis; concern about any publicity.</p>	<p>Staff has analyzed existing models; produced prototype enhanced models.</p>	<p>Fund staff to implement and test system for regular assessment of risks; decide how best to disseminate results confidentially within Fund.</p>
<p>II. Strengthening Financial Systems</p>				
<p>Financial market supervision and development.</p>	<p>Strengthen focus of Fund surveillance on health and vulnerabilities of financial sector, including linkages between macroeconomic policies and banking system soundness. Enhanced technical assistance on a wide range of financial sector areas</p>	<p>Supportive</p>	<p>Work has begun on strengthening surveillance of countries' financial systems in the context of Article IV.</p> <p>The Financial Sector Liaison Committee (FSLC) established in September 1998</p>	<p>Fund staff to carry out a number of pilot studies and report to Board thereafter seeking guidance on next steps.</p> <p>FSLC will continue to coordinate the work of the Fund and World Bank in this area.</p>

			to enhance the collaboration process between the World Bank and the IMF. Committee has initiated actions to enhance coordination and effectiveness of work programs, and develop guidelines. Agreement in principle to coordinate joint financial sector monitoring and assessment program.	
III. Capital Account Issues				
Capital controls. Achieving orderly liberalization; possible use of certain types of capital controls.	Identify circumstances when there may be a role for capital controls, and approaches to achieving orderly liberalization.	Controls may make sense in certain circumstances to provide a (temporary) breathing space, but cannot substitute for more fundamental policy action. A consistent macro-policy framework and supporting financial sector reforms are crucial in achieving orderly liberalization.	Board meeting of 3/24/99 reached agreement on broad principles but differences remain on operational questions about the use and effectiveness of capital controls.	Fund staff to study further detailed country cases, focusing on the use and effectiveness of specific controls and on experiences with the liberalization of different aspects of the capital account, and aimed at drawing conclusions for best practices.
IV. Involving the Private Sector				
Raise cost of short-term cross-border capital flows.	Make capital requirements a function of type of funding; have monetary authority charge banks directly for existence of sovereign guarantee; and on the lending side, assign higher risk weight to interbank lines under Basle Accord.	Most Directors saw merit. Urged consideration on fast track with goal of early implementation of proposals that can gather international support.	None.	Basle Committee on Banking Supervision (BCBS) to address issue.
Contingent credit lines (as in Argentina and Mexico).	Contract market-based contingent credit lines with commercial banks to trigger liquidity support in times of crisis.	Generally supportive, but noted that experience was not yet sufficient to form judgment, and that care was needed in design.	Some experience being gained.	Official Community —assess whether there is a role for official sector to support. Debtor countries —discuss with creditors.

<p>Call options. Embed call options in interbank loan agreements.</p>	<p>Introduce ability of debtor to extend maturity of loans under pre-specified conditions.</p>	<p>Some Directors cautioned about interfering with key short-term liquidity market; others thought further consideration warranted as way of addressing volatility of short-term capital flows.</p>	<p>None.</p>	<p>Official community: Further examination required.</p> <p>Debtors should discuss with creditors.</p>
<p>Creditor-debtor councils. Organize creditor-debtor councils to improve the flow of information.</p>	<p>Decision on desirability of such councils, and their composition.</p>	<p>Mixed. Directors considered it desirable to improve information flows, but noted representational issues and risks including those relating to insider information.</p>	<p>None.</p>	<p>International community (Fund, G-10, IIF, etc.) to assess and, if appropriate, advance specific proposals.</p>
<p>Fund dialogue with the private sector.</p>	<p>Decision on desirability of various approaches to closer links with the private sector.</p>	<p>Mixed. Agreement on need to improve flow of information; noted risks relating to inside information.</p>	<p>Ongoing discussion.</p>	<p>Fund and others- Further examination required.</p>
<p>Bond covenants. Modify the terms of foreign sovereign bond contracts. G-10 proposal.</p>	<p>Introduce sharing clauses and majority decision rules to speed negotiation process. Introduced to market in concerted initiative by major industrial governments.</p>	<p>Directors supported moving forward expeditiously with provisions for bond clauses, including sharing clauses, qualified majority conditions, and collective representation provisions.</p> <p>A few Directors noted British-style Trust Deed Bonds could be useful model.</p>	<p>G-22 has consulted with private sector on model clauses. Fund staff paper identifies relevant features of bond contracts.</p>	<p>National authorities: Concerted action by industrial country governments as well as by emerging market countries. Could perhaps build on endorsement by trade association of clauses (not yet underway).</p> <p>Fund and national authorities: Encourage industrial countries to introduce such terms in their own bond contracts.</p>
<p>Sovereign arrears. Allow Fund to lend into sovereign arrears to private bondholders to support adjustment measures during negotiations.</p>	<p>Extend 1989 policy to allow Fund to lend into arrears to private bondholders.</p>	<p>Building on an earlier discussion, Directors agreed to extend the 1989 policy on lending into arrears on a case-by-case basis.</p>	<p>Done, in principle.</p>	<p>Fund Board. Further discussion required to make operational.</p>
<p>Nonsovereign arrears. Allow Fund to lend into nonsovereign arrears arising from the imposition of exchange controls, again to support adjustment measures during negotiations.</p>	<p>Extend further the 1989 policy to lend into nonsovereign arrears.</p>	<p>Directors considered that the Fund should be willing to lend into arrears under these circumstances, again on a case-by-case basis.</p>	<p>Done, in principle.</p>	<p>Fund Board. Further discussion required on conditions under which Fund would proceed.</p>

Litigation stays. Impose stay on creditor litigation to facilitate orderly nonsovereign debt renegotiation.	Mechanisms to provide a means to impose a stay on enforcement of creditor claims.	A number of Directors thought that amending Article VIII, Section 2(b) warranted further consideration; others did not see the need for such action.	None.	Fund Board. Further consideration required.
V. Strengthening the International Monetary System-Systemic Aspects				
Interim Committee. Strengthen and/or transform Interim Committee.	Decision on various proposals identified by staff, including transformation of Interim Committee to Council.	Unanimous on strengthening Interim Committee. Diverse views on transforming Interim Committee.	Report of the IMF Executive Board prepared.	Interim Committee to discuss this issue.
Exchange rates. Study measures that could improve functioning of international monetary system.	Fund staff study of exchange rate regimes, asset markets, and international capital flows. Focus on systemic issues.	Diverse views on merits of fixed, floating regimes in liberalized financial markets.	Board paper under preparation for consideration after Interim Committee meeting.	Fund Board to hold seminar after Interim Committee meetings.
VI. The Fund's Financial Facilities and Resources				
CCL. A possible role for the IMF in providing contingent credit lines (CCLs).	Decision by the Fund Board whether to proceed with concept and establish the CCL.		Board has reached a decision to create a Fund-financed CCL.	
Increase in Fund's quotas and entry into force of IMF's New Arrangements to Borrow (NAB)	Approval of members.	Endorsed.	Implemented.	Fund Board to review quota formulae in the context of the 12th General Review.
ESAF/HIPC. Secure full financing for interim ESAF and the Fund's participation in HIPC Initiative	Bilateral contributions and direct contributions from Fund's own resources.	Status of financing was discussed by Fund Executive Board on April 16.	Ongoing.	Continue efforts to secure full financing of these initiatives.

Acronyms	
APEC	Asia Pacific Economic Cooperation
BCBS	Basle Committee on Banking Supervision
CPSS	Committee on Payment and Settlements Systems
CGFS	Committee on the Global Financial System
FSLC	Financial Sector Liaison Committee
IAIS	International Association of Insurance Supervisors
IASC	International Accounting Standards Committee
IATF	Inter Agency Task Force on Finance Statistics
IFAC	International Federation of Accountants
IIF	Institute of International Finance
IOSCO	International Organization of Securities Commissions
LOIs	Letters of Intent
MEFPs	Memorandum of Economic and Financial Policies
OECD	Organization for Economic Cooperation and Development
PFPs	Policy Framework Papers
UFR	Use of Fund Resources
WEMD	World Economic and Market Developments

APPENDIX I

**Developing International Standards in Areas Outside the Fund's
Direct Operational Concern: Current Status**

Standard	Key Agency(s) responsible	Status
Securities Market Regulation	International Organization of Securities Commissions (IOSCO)	<p><i>Objectives and Principles of Securities Regulation and Disclosure Standards to Facilitate Cross-Border Offering and Initial Listings by Multinational Issuers</i> were endorsed by the IOSCO membership in September 1998.</p> <p>IOSCO is a forum for cooperation between national securities regulators. Its recommendations are meant to be advisory, rather than binding, on the membership.</p>
Insurance Regulation	International Association of Insurance Supervisors (IAIS)	<p>In September 1997, the IAIS issued a compendium of principles, standards and guidance papers. Three additional standards were issued in September 1998 relating to licensing, on-site inspections and supervision of derivatives.</p> <p>The IAIS is made up of insurance supervisors. It is charged with developing internationally accepted principles and standards on insurance supervision, and with training insurance supervisors from emerging economies. The IAIS recommendations are advisory, rather than binding, on the membership. The IAIS has, however, developed a self-assessment program for its members.</p> <p>The IAIS has solicited assistance from the World Bank</p>

		in distributing the principles, standards and guidance notes to insurance supervisors, and also in promoting the implementation of the underlying standards.
Accounting	International Accounting Standards Committee (IASC)	<p>A comprehensive set of <i>International Accounting Standards</i> (IAS) have been promulgated by the IASC. Most recently, the IASC completed a work program agreed with IOSCO on the development of a core set of standards. An IOSCO technical committee is now evaluating whether it should recommend endorsement of the IASC core-standards to its members for use by foreign issuers in cross-border listings and offerings. For the public sector, the International Federation of Accountants (IFAC) is formulating accounting standards, which are based on the IAS, which are expected to be completed by 2001. The Fund and the World Bank participate on the Public Sector Committee (PSC) of IFAC.</p> <p>Membership in IASC is predominantly private sector and carries no requirement that IAS be used. Adoption of IAS is the decision of national authorities or, where relevant, self-regulatory organizations. Some stock exchanges require financial statements in accordance with IAS as a condition for listing.</p>
Auditing	International Federation of Accountants (IFAC)	<p>International standards on auditing (ISAs) and audit practice statements (IAPs) have been formulated by IFAC through its International Auditing Practices Committee (IAPC). IFAC works with IOSCO on ISA for cross-border offerings and reporting by foreign issuers.</p> <p>The majority of IFAC members uses the ISA as a basis for developing their own national standards. The standards developed by IFAC/IAPC have no legal force; members are simply expected to use best efforts to see that IFAC and IASC pronouncements are used nationally. However, the IFAC does encourage members to undertake self review of their domestic auditing practices to evaluate how well they compare with the ISA.</p>
Bankruptcy	United Nations Commission on International Trade Law (UNCITRAL), World Bank, International Bar Association	<p>UNCITRAL adopted Model Law in May 1997 for cross-border insolvency and this is now under consideration in a number of countries.</p> <p>The World Bank is providing information to governments on good practices for reform of insolvency systems and institutional development, including the role of specialist bankruptcy courts. Discussions are underway with the International Bar Association and multilateral organizations on an initiative to develop guidelines for sound insolvency laws and the incentives for debtors and creditors to utilize insolvency mechanisms.</p> <p>The Fund staff has prepared a report on effective and orderly insolvency procedures. The World Bank intends to use this report in its efforts to develop guidelines for effective insolvency regimes for developing countries. In</p>

		addition, UNCITRAL has expressed strong interest in collaborating with the Fund and Bank in this area
Corporate Governance	OECD, World Bank, Basle Committee	<p>OECD Task Force has circulated draft principles for public comment. The principles are expected to be considered for endorsement at the time of OECD Ministerial meeting in May 1999. The principles will be non-binding on the OECD membership.</p> <p>The World Bank Group has:</p> <ul style="list-style-type: none"> • supported, though lending operations, reform of corporate governance in developing countries both before and after the Asian Crisis; • undertaken corporate governance assessments in 8 countries under the auspices of APEC; and • produced policy papers on corporate governance (including a framework paper which is near completion), organized or participated in international conferences and maintained a web site on this topic.
Other	Committee on Payment and Settlements Systems (CPSS)	The CPSS is working to improve the robustness of payments systems.
	World Bank	The World Bank is developing general principles of good practices in social policies
	Committee on the Global Financial System (CGFS -formerly Euro-Currency Standing Committee, ECSC)	The CGFS is working to identify practices and structures that support deep and liquid forward markets.
	Institute for International Finance (IIF)	The IIF has organized a series of working groups to identify best practices and develop standards in a number of areas. These include data standards for emerging market economies; best practices for financial firms to manage risk exposure to emerging market economies; and common financial industry definitions for non-performing loans and criteria for loan classification.

¹As described in the Managing Director's Report to the Interim Committee, October 1, 1998.

²World Bank, *Principles of Good Practice in Social Policy: A Draft Outline for Discussion and Guidance*, April 14, 1999, DC/99-4.

³The Fund's archives policy will be reviewed in two years.

⁴These case studies, for Argentina, Australia, and the United Kingdom, are accessible through the Fund's web site along with a solicitation for feedback.

⁵[Appendix I](#) provides the current status of developing standards in areas outside the Fund's direct operational concern.

⁶The World Bank is in the process of developing systems for assisting countries to assess structural sources of vulnerability and providing support for institutional strengthening and capacity building (*Strengthening the Underpinnings of the Market Economy: International Standards, Principles and Best Practices, and the Role of the World Bank*, April 22, 1999, DC/99-10).

**Back to Basics: Interrelation of Letter of
Credit and Modern Financial Markets**

Professor E.P. Ellinger

CONFERENCE ON NEW INTERNATIONAL FINANCIAL ARCHITECTURE

BACK TO BASICS:

INTERRELATION OF LETTER OF CREDIT

AND

MODERN FINANCIAL MARKETS

SYNOPSIS

The first Part of this paper discusses the distinction between Import and Export Letters of Credit and examines the manner in which both types of facility promote the efficient functioning of international trade and of the international banking transactions related to them. Reference is made in this context to the discount and negotiation of letters of credit and documents tendered thereunder, to *à forfait* financing, to silent confirmations, to standby credits and to certain stocks and money market transactions.

In its second Part, the paper covers the credit aspect of import letters of credit. It highlights problems arising in the granting of securities over goods, the problems of perfecting "charges", the use of facilities by nominees and the securities available in the case of back to back arrangements. The doctrine of strict compliance, and modern problems arising in respect of it, as well as trust receipts, are also covered in this Part.

The third part deals with the role played by Export Letters of Credit in Modern Financial Markets. The cardinal articles of the UCP-500 are examined as are issues arising as regards the position of negotiating and discounting banks. Bank acceptances, deferred payment undertakings and the role of reimbursing banks are also discussed in some detail. The autonomy doctrine and the fraud exception including important decisions of American courts, are, likewise, discussed in this Part.

The last Part of the paper deals with issues of the conflict of laws, arising principally from the fact that most major players have become multi-nationals. The two cardinal issues, which are jurisdiction and the doctrine of *forum non-conveniens*, are analysed in the light of recent authorities.

E.P. Ellinger

BACK TO BASICS
INTERRELATION OF LETTER OF CREDIT
AND
MODERN FINANCIAL MARKETS

DETAILED OUTLINE

I. PRACTICAL IMPLICATIONS OF LETTER OF CREDIT FINANCING

Subject:

Bank's role in assisting the importer by "letter of credit financing": granting credit and trying to assist in ensuring due performance by exporter. Bank's role when acting for exporter: assisting him to secure due payment and effective advances. Use in this regard of modern financial markets (the negotiation and à forfait financing; silent confirmations); standby credits in stocks and money market transactions (the "through letter of credit").

Materials to be referred to:

Benjamin's Sale of Goods, 5th ed., §§23-003 et seq; the ISP98, promulgated by the Institute of International Banking Law and Practice Inc. and approved by the International Chamber of Commerce (the ICC), art. 2.

II. PRACTICAL IMPLICATIONS TO ISSUING BANK OF THE GRANTING OF LINE OF CREDIT (OR LETTER OF CREDIT FACILITY)

Topics:

(i) Import letters of credit: the credit aspect; the need for adequate security, problem of goods as security (with special reference to perishable goods and seasonal goods); need to consider tenor; allowing use of facility by "nominees"; special problems of acting for middlemen, security in case of back-to-back arrangements.

(ii) Problem of strict compliance: current law and doubts left by UCP-500 (art. 13(a); the "bifurcated" analysis, trivialities and misprints; rejection formula (UCP-500, art. 13(b) and 14); consulting the applicant (need issuer obey applicant's instructions?); is a doctrine of "substantive compliance" to be preferred to "strict formal compliance"?; practices in certain domestic markets; new clauses in certain banking forms; use of standby credits in lieu of commercial credits.

(iii) Trust receipts: their nature; question of registration; inherent dangers (rights of innocent bona fide purchaser); problems of fixtures, annexures and co-mingling; need for extreme caution in drafting. Advisability of avoiding use of words such as "hypothecation", "continuing security" and language denoting a trust without transfer.

Materials to be referred to:

(i) *Benjamin's Sale of Goods* §§ ; UCP-500, arts. 9, 10, 48, 49; *Korea Industry Co. Ltd v. Andoll* [1989] 3 M.L.J. 449; *Singer & Friedlander v Credit-Anstalt Bankverein* [1981] Com L.R. 69; *Bank Negara Indonesia v Larizu (S) Pte Ltd.* [1988] A.C. 583

(ii) *Seaconsar Far East Ltd. v. Bank Markazi Jamhuri Islami Iran* [1993] 1 Lloyd's Rep. 236 at p 239 per Lloyd L.J.; *Glencore International AG v. Bank of China* [1996] 1 Lloyd's Rep. 135 at p 150; cf. *Seaconsar Far East Ltd v Bank Markazi Jamhuri Islami Iran*, decision of English C.A. of 30 July 1998 (affg Tuckey J. [1997] 2 Lloyd's Rep. 89); *Karagunda Ltd. v. Midland Bank Plc*, decision of English C.A. of 27.4.1999, affg. [1998] 2 Lloyd's Rep. 173 (Diamond Q.C.); *Hing Yip Fat Co Ltd v Darwa Bank Ltd.*, [1991] 2 HKLR 35; *Brenntag v. Norddeutsche Bank*; *Kungat-Zenecon Construction Pte Ltd. (in Liq) v. Arab Bank plc* (Judith Prakash JC, affd. [1997] 3 S.L.R. 770, esp. pp 779-781

(iii) Structure of Bills of Sale Legislation; *Re Hamilton Young & Co.* [1905] 2 K.B. 381 affd. 772; *Re David Allester Ltd.* [1922] Ch. 211; *Lloyds Bank v. Bank of America* [1938] 2 K.B. 147; *United Malayan Banking Corp. Bhd. v. Lim Kang Seng* [1994] 2 S.L.R. 787.

III. LETTERS OF CREDIT IN THE MODERN FINANCIAL MARKETS

1. THE DISCOUNT MARKET

Topics:

Is negotiation permitted in a given credit? (see UCP-500, art. 10(b)(i)). Meaning of negotiation: UCP-500, art 10(b)(ii). The role of the exporter (beneficiary's) bank: negotiating bank, discounting bank, advancing bank, or collecting bank (UCP-500, arts. 9, 10); bank acceptances and deferred payment undertakings; negotiation with recourse and à forfait {without recourse} discounting; need to ensure compliance of documents; the examination process; the "currency" problem (forward contracts).

Materials

Bankers Trust Co. v. State bank of India [1991] 1 Lloyd's Rep. 587, affd. [1991] 2 Lloyd's Rep. 443 (C.A.); *Amixco Asia (Pte) Ltd. v. Bank Bumiputra Malaysia Brhd* [1992] 2 S.L.R. 943; *Union Bank of Switzerland v. Indian Bank* [1993] 3 S.L.R. 371 (Goh Joon Seng J); revd. *Indian Bank v Union Bank of Switzerland* [1944] 2 S.L.R. 121, Bills of Exchange Act, s. 16; *Chalmers & Guest on Bills of Exchange*, 15th ed., pp.

2. The Reimbursement Procedure

UCP-500, art. 19 (note tendency to go against clause (b), connection with art. 14; Bankers Trust problem: the tested telex for reimbursement; issues related to insolvency.

3. Risks Assumed by Negotiating Bank

Topics

(i) Political risk and transmission risks: UCP-500, art. 17, 16; divergent views re conformity; right to

insist on issuer's compliance with rejection procedure.

(ii) Fraud and collusion: fortunately a rare problem, authenticity of telex messages (see UCP-500, art. 15 & 16); difference between divergent domestic legal systems (meaning of "fraud"); forum shopping; tendency to protect innocent third party.

(iii) General issue of recourse: UCP-500, art. 10.

Materials

(i) *Harlow and Jones Ltd. v. American Express Ltd* [1990] 2 Lloyd's Rep. 343; *AA Valibhoy & Sons (1907) Pte Ltd. v Bank Nationale de Paris* [1994] 2S L.R. 772, *Rudolph Robinson Steel Co v Nisho Iwat Hong Kong Corp. Ltd.*, decision of the High Ct of H.K. of 20 April 1998, and, generally, Uniform Rules for Collection 1995, I.C.C. Brochure 522.

(ii) *United City Merchants (Investments) Ltd v. Royal Bank of Canada* [1983] A.C. 168 (rev'ng [1981] 1 Lloyd's Rep. 604, which varied [1979] 2 Lloyd's Rep. 498 (English law approach); *Itek Corp. v. First National Bank of Boston*, 730 F. 2d 19 (1984); *Warner v Central Trust Co.*, 715 F. 2d 1121 (1983) (U.S. seminal cases); *Bank of China v Standard Chartered Bank of Australia*, unreported, decision of the N.S.W. Ct of App. of 16 July 1991 (authenticity of *l/c*); *Standard Bank of London v Bank of Tokyo* [1995] 2 Lloyd's Rep. 169 (Waller J: re tested telex); U C C., s. 5-114(2) (protection of negotiating bank); *Discount Records v. Barclays Bank* [1975] 1 W.L.R. 315 (do)

(iii) *Sassoon v. International Banking Corporation* [1927] A.C. 711, 731 (right of recourse (general common law rule on recourse in *l/c* transactions).

IV. ENFORCEMENT PROBLEMS

Topics

Problems arising from banks becoming multi-nationals; general rules re jurisdiction; stays; doctrine of forum non conveniens.

Materials

UCP-500, article 2 (branches of one bank in different countries); *Spiliada Maritime Corporation v Cansulex Ltd.* [1987] A.C. 460; *Power Curber International Ltd. v. National Bank of Kuwait* [1981] 2 Lloyd's Rep. 394; *European Asian Bank AG v Punjab and Sind Bank (No. 1)* [1982] 2 Lloyd's Rep. 356; *Bank of Baroda v. Vysya Bank Ltd.* [1994] 2 Lloyd's Rep. 87 (Mance J); *Bank of Credit and Commerce Hong Kong Ltd. v. Sonali Bank* [1995] 1 Lloyd's rep. 227 (Cresswell J).

**Insolvency Law Reform: International
Financial Insolvencies**

Mr. Philip Smart

INSOLVENCY LAW REFORM: INTERNATIONAL FINANCIAL INSOLVENCIES

*Philip Smart
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'The Asian crisis offers an opportunity to direct the sort of attention to cross-border insolvency that has lately been devoted to standards of financial supervision. Even if progress can only be piecemeal, that opportunity should not be missed.'

(International Insolvencies in the Financial Sector, A Study Group Report, Group of Thirty (1998) p 19)

The links between insolvency law, particularly cross-border insolvency law, and the financial sector have recently been explored in a Study Group Report by the Group of Thirty on International Insolvencies in the Financial Sector.¹ The Group of Thirty (in co-operation with INSOL International) examined the issues that would likely arise upon the insolvency of an international financial institution - for example, a commercial bank, financial conglomerate or insurance company. The Report emphasised that appropriate and efficient insolvency laws and procedures provided an assurance to national authorities that cross-border co-operation would preserve value rather than 'assist looting aboard'.² In addition:³

'...the assumption that institutions are in place to deal efficiently with insolvency, both financial and non-financial, should improve market discipline and reduce moral hazard by reducing the chances that supervisors will be forced to step in to prevent messy failures.'

On the downside, however, the Report also noted that:⁴

'... there are serious questions about the effectiveness of supervision, the ability of supervisors to intervene in the affairs of failing financial institutions, the reliability of

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1. (1998) Group of Thirty: see <http://www.group30.org>
 2. Ibid at p 4.
 3. Ibid at pp 4-5.
 4. Ibid at p 5.

safety nets and the effectiveness and impartiality of courts in a number of countries, and particularly emerging markets.'

These quotes from the Report are given here to provide a flavour of the sort of issues that are raised when insolvency law and the financial sector are brought together.⁵

This paper has three main parts. First, by way of introduction and background, it is sought to highlight certain aspects of domestic insolvency law which have a direct bearing upon the topics and areas which other speakers have dealt with over the last days - particularly, in relation to banks and corporate governance generally. Secondly, moving to international (or cross-border) insolvency, I intend to draw brief attention to a couple of related points made in the Guide to the UNCITRAL Model Law on Cross-Border Insolvency.⁶ This concerns in-bound investment, as well as fraud. Finally, returning to the Group of Thirty Report, it is proposed to examine the Report's recommendations for lessening the risk of systemic collapse upon the insolvency of an international financial conglomerate.

5. Of course, the 'first line of defense' when dealing with a major financial insolvency will be the relevant national supervisor: 'In the event of insolvency, and ideally in advance of balance-sheet insolvency, supervisors in the G-10 countries would undertake resolution procedures under the special legal authority available to supervisors and central banks, without recourse to general insolvency procedures in the courts ... Yet while this supervisory imperative may be the same across countries, the legal authorities available to deal with a financial insolvency vary greatly from country to country ... In addition, virtually none [of the relevant legal authorities] were written with attention to the cross-border dimensions of an insolvency, offering no mechanism for dealing with matters outside of [the] home jurisdiction, or reconciliation of national differences.' (Ibid, p 4.).

6. The Model Law on Cross-Border Insolvency was adopted by the United Nations Commission on International Trade Law at its thirtieth session (Vienna, 12-30 May 1997). The text, as well as the explanatory Guide, can quite conveniently be found at <http://www.un.or.at/uncitral/en-index.htm>

A. Background Issues

Although international financial architecture and insolvency law may not always be thought of as closely connected,⁷ it is obvious that, at the domestic level, banking law and practice is intimately bound up with insolvency law. The availability of secured interests (not to mention quasi-security) and their enforceability following the insolvency of a borrower is one clear example. The enforceability of netting arrangements is another - indeed, the attention given to netting in the evidence presented before the House of Lords Select Committee on the EU Convention on Insolvency Proceedings stands out.⁸ When it comes to the restructuring of financially troubled businesses – a hot topic in the light of the modern 'corporate rescue culture' - it will very often be the case that a company's bankers will have a crucial role to play in either an informal work out⁹ or a more formal rescue procedure (such of the administration regime in

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7. Not least because national regulators will seek wherever possible to have in place a regulatory framework that enables intervention well before the onset of insolvency. Although, of course, it is recognised that an efficient insolvency regime is one aspect of the required legal framework in which securities regulation operates, see, e.g., the Objectives and Principles of Securities Regulation of IOSCO (October 1998) para. 5 and Annexure 3 (see, for instance, <http://www.hksfc.org.hk/eng/pub/iosco.htm>)
 8. Seventh Report of the House of Lords Select Committee on the European Committees, HL Paper 59 (1996). It seems that more questions were raised in evidence about netting than about almost any other issue.
 9. In Hong Kong, Guidelines on Corporate Difficulties were circulated by the Hong Kong Association of Banks (see Circular No. S/98/067 (3 April 1998)), the introduction to which states:

'This circular contains formal but non-statutory guidelines covering how institutions should deal with customers in financial difficulty where the customer is dealing with multiple banks. There have been many instances where the constructive approach suggested below has made possible the survival of businesses which otherwise would have failed. These are supported by H.K.A.B., which would expect all members to use their best endeavours to follow these guidelines.'

UK or the proposed provisional supervision in HK).¹⁰ All in all, one would not suggest that there was any exaggeration in the memorandum submitted by the British Bankers Association to the aforementioned House of Lords Select Committee, when it was stated:¹¹

'We believe that confidence about the operation of the UK's insolvency rules among non-UK firms is a significant factor contributing to the UK's leading role in international financial markets.'

Leaving to one side the opinion of the bankers, it is also readily apparent that insolvency procedures have a significant role to play in relation to corporate governance generally. When a liquidator (or administrator or equivalent) steps in to take control of a failed or failing company, there is every likelihood (assuming that the liquidator's independence is not in question) that any skeletons will be dragged out of the management cupboard.¹² Any effective insolvency regime must ensure that the office holder has wide investigatory powers; and it will be noted that the English courts have stated that the powers to examine directors are a means of enforcing

10. See Hong Kong Law Reform Commission Report on Corporate Rescue and Insolvent Trading (October 1996), which is currently available for downloading from <http://www.info.gov.hk/justice/department/6/index.htm>

11. Above n 8 at p 27 of the evidence.

12. An interesting Hong Kong example arising out of the crash of October 1987 is Chingtung Futures Ltd (in liquidation) v Arthur Lai [1994] 1 HKLR 94. The defendant was the chairman and controlling shareholder of the plaintiff company, a brokerage house, which had incurred a liability of some HK\$83 million following default by a customer. It seemed the customer, by way of various shell companies, was a Thai army general – although the precise identity of this general appears to have been unknown to the defendant and the company. The general's account had been traded very heavily whilst inadequately margined or over-exposed. In response to the company's claim (brought after the company had gone into liquidation) that the defendant's supervision of the account had been negligent, the defendant asserted, *inter alia*, that the company had ratified any breach before it went into liquidation. The court held (*ibid*, at 115 – 116) that: (a) on the facts there had been no such ratification; and (b) even if there had been such a ratification - brought about as a result of the defendant's control - such ratification (at a time when the company was insolvent) would not have defeated the claim of the company in negligence.

'commercial and business morality'.¹³ Even where there is no suggestion of dishonesty or recklessness, many insolvency regimes have provision for 'wrongful' or 'insolvent trading' and allow for the disqualification of 'unfit' directors - thereby, in theory, bringing objective criteria into play and improving standards of managerial behaviour and competence.¹⁴

It will be noted that the disqualification proceedings following the collapse of Barings¹⁵ attracted considerable media interest. No doubt now that an inspector has been appointed to look into the Peregrine insolvency,¹⁶ disqualification proceedings (or possible disqualification proceedings) will similarly be a point of interest in Hong Kong.

In summary, the importance of insolvency law is reflected in the attention now given to it by bodies such as the IMF.¹⁷

13. Re Seagull Manufacturing Co Ltd [1993] Ch 345 at 355, quoting from the Report of the Review Committee on Insolvency Law and Practice (Cmnd 8558) (June 1982) at para. 656; and see also Re Seagull Manufacturing Co Ltd (No 2) [1994] Ch 91.

14. The statistics on corporate insolvency in Hong Kong have shown a significant (but expected) rise since the beginning of the Asian financial crisis. In 1997 there were 503 compulsory winding up orders made and 107 creditors voluntaries were commenced. The figures for 1998 are 723 and 211 respectively. The figures for the first 4 months of 1999 are 215 and 134, respectively. The statistics are up-dated monthly on the worldwide web: see <http://www.info.gov.hk/cr/key/chart3.htm> (for creditors voluntaries) and <http://www.info.gov.hk/oro/content/report/16.htm> (for compulsories). The number of disqualification orders made in 1997-98 was apparently only 44 (ibid).

15. See Secretary of State for Trade and Industry v Baker (No 1) [1998] BCC 583.

16. See South China Morning Post, 23 April 1999, reporting that Richard Farrant has been appointed as the inspector.

17. As the Group of Thirty Report states, at p 8; 'In the light of the Asian experience, the Economic Summit countries, the G-10 and the Interim Committee of the IMF have all placed promotion of stronger insolvency regimes on their agendas.'

B. International Insolvencies: General

The increasing number of international insolvencies is a consequence of the fact that more and more business activities are being conducted across national boundaries.¹⁸ The development of e-commerce over the next few years may even make the concept of national boundaries irrelevant.¹⁹ Any modern insolvency regime should take particular account of the following passages from the Guide to the UNCITRAL Model Law on Cross-Border Insolvency.²⁰

‘13. The increasing incidence of cross-border insolvencies reflects the continuing global expansion of trade and investment. However, national insolvency laws have by and large not kept pace with the trend, and they are often ill-equipped to deal with cases of a cross-border nature. This frequently results in inadequate and inharmonious legal approaches, which hamper the rescue of financially troubled businesses, are not conducive to a fair and efficient administration of cross-border insolvencies, impede the protection of the assets of the insolvent debtor against dissipation, and hinder maximisation of the value of those assets. Moreover, the absence of predictability in the handling of cross-border insolvency cases impedes capital flow and is a disincentive to cross-border investment.

14. Fraud by insolvent debtors, in particular by concealing assets or transferring them to foreign jurisdictions, is an increasing problem, both in terms of frequency and magnitude. The modern interconnected world makes such fraud easier to conceive and carry out. The cross-border co-operation mechanisms established by the Model Law are designed to confront such international fraud.’

C. International Insolvencies: The Financial Sector

There are many ways of dividing up insolvencies and insolvency law: personal and corporate; domestic and international; small-scale or commercially significant. But for present purposes

18. See Smart, Cross-Border Insolvency (London, Butterworths, 2nd Ed, 1998) p v.

19. At least in certain commercial situations.

20. See above n 6 (emphasis added).

there is a quite useful (although by no means exact) distinction between financial insolvency and non-financial (or commercial) insolvency. The issues raised in and potential consequences flowing from the insolvency of a major car parts manufacturer, for example, are very different from those raised in the collapse of a commercial or investment bank.

The Group of Thirty Report notes, in particular, that the failure of a commercial bank carries with it the danger of a loss of confidence in similar institutions as well as other systemic risks:²¹

‘The losses caused by the exposures of creditors and counterparties are an obvious mechanism through which systemic risks can develop.’

Accordingly, there is a particularly pressing need for a quick response from regulators and insolvency practitioners when dealing with a financial insolvency - especially if it is envisaged that the institution is perhaps to carry on business in some (reorganised) form or other.²²

The recommendations put forward by the Group of Thirty can perhaps be divided into two main areas.

Supervisors

The Group recommends that encouragement should be given to regular exchanges of information between national supervisors of financial conglomerates:²³ lines of communication should be kept open. The idea is that the more familiar a regulator is with a foreign insolvency

21 Above n 1 at p 32.

22 Ibid at p 13: ‘Experience with financial insolvencies in a variety of countries has demonstrated that the surest way to minimize losses both within the firm and to the system as a whole is to take prompt and decisive action to end the insolvency, whether by closing the firm or transferring ownership of an entire firm or its assets.’

23. Above n 1 at pp 8-10.

and regulatory regime, the more likely that regulator is to have trust in (and co-operate with) that regime. US transnational bankruptcy law and practice would seem to bear this out.²⁴ Regulators, the Group suggests, should also consider the adequacy of an applicant's domestic insolvency law regime when making licensing or similar decisions.²⁵

Legislation

The Group puts forward a number of inter-connected suggestions to strengthen: (a) national insolvency and legal regimes (such as ensuring the effectiveness of close out netting arrangements, that the sharing of information amongst supervisors and insolvency practitioners is facilitated and, in particular, not blocked by secrecy statutes, or that supervisors have adequate powers of intervention);²⁶ and (b) cross-border insolvency regimes²⁷ - here many of the suggestions have equivalents in the UNCITRAL Model Law. Thus it is suggested that provision should be made to ensure that access and recognition shall be granted to a foreign insolvency representative and that such recognition should, if possible, be actively supported by local regulators.²⁸

Comment

The Group's Report tends to be rather general in its recommendations, but it must be

24. The sort of assistance that might be obtained by a foreign representative applying in the Bankruptcy Court for the Southern District of New York is very different from the approach that would likely be taken by a Bankruptcy Court in Idaho or Colorado.

25. Above n 1 at 11-12.

26. Ibid at pp 14-15.

27. Ibid.

28. Ibid.

remembered that there are very different levels of experience and sophistication when it comes to various countries' insolvency regimes. Some systems still try to 'ring-fence' assets - even going so far as treating a local branch office of a foreign company as a separate legal entity (rather than a branch).²⁹ In such jurisdictions merely breaking down the fence will be a major achievement.

For anyone looking for specific reform proposals in (more or less) the form of legislation, the UNCITRAL Model Law is the starting point. The Model Law provides for such matters as:³⁰

- equality of treatment between foreign and local parties
- recognition of foreign proceedings
- preventing the subsequent attachment of local assets
- staying local actions against the insolvent
- allowing the foreign representative to commence local insolvency proceedings
- allowing the foreign representative to examine local witnesses

29 Note Re BCCI SA (No 10) [1997] Ch 213, in passing.

30 See Smart, above n 18 at pp 8-9.

But for regulators or lawyers looking for ways to tackle an actual insolvency problem, then guidance can already be found in the IBA Cross-Border Insolvency Concordat.³¹ The Concordat, which has its origins to a certain extent in the Maxwell³² insolvency of the 1990s, has been designed as something in the nature of a 'road map' to assist insolvency practitioners and others actually faced with concurrent proceedings (in relation to the same insolvent company) in two or more different jurisdictions. Rather than leaving the insolvency practitioners and regulators to start from scratch and try to forge a one-off agreement (acceptable to their respective courts etc) as to the proper co-ordination of the two sets of proceedings, the Concordat sets out a small number of essential principles which can be adopted, with appropriate modification, to suit the particular facts involved. Experience of commercial insolvencies has revealed the sorts of issues that are likely to be raised where there are concurrent re-organisations or liquidations; and the Concordat provides a clear and ready-made basis for negotiation at the earliest stages of the process. Similar issues would inevitably arise in an international financial insolvency. The idea is that, assuming the facts require it, once the responsible parties have adapted the Concordat to come up with their own particular agreement or protocol, rapid progress with the actual administration of the insolvency can be made. (The Concordat is likely to prove particularly useful where the two prima facie competing jurisdictions have a tradition of informal, non-treaty based co-operation and assistance in international insolvency matters.)³³ Where one is dealing with two

31 See Leonard (1996) 24 Int Bus Law 203 and (1997) 6 IIR 127.

32 See Smart, above n 18 at pp 332-334.

33 Leonard, above n 31, at p 132, sets out the following observation of Farley J in Re Everfresh Beverages Inc, unreported, Ontario Court of Justice, 20 December 1995: 'I would congratulate the parties for their initiative in taking their lead from the Concordat .. and in crafting the protocol which I believe will prove of significant

systems of insolvency law of roughly equal sophistication, it is unlikely (except in rare cases) in the context of the overall insolvency process to make a great deal of difference whether a particular matter is regulated by one law or the other:³⁴ for example, the collection and realisation of assets under Canadian law is probably just as efficient as under United States law. Perhaps what matters more is that the relevant parties are aware from the outset who is responsible for what. Hence the principles under the Concordat concern such practical matters as the receipt of relevant notices, the right to appear in all proceedings, the division of responsibility between the various proceedings, the use of avoidance powers, as well as the mutual recognition of orders (including any ultimate compromise or discharge) made by the courts in either jurisdiction.

value to all concerned, both in the aspect of eliminating certain procedural difficulties, reducing legal expenses and uncertainties and hopefully in maximizing everyone's recovery.' Note also Re Hackett 184 Bankr. 656 (Bankr., S.D.N.Y. 1995).

34 See the comments of Lord Hoffmann in (1995) 4 IIR 97 at 100-101.

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Work in Progress: Preliminary and incomplete

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Comments welcome

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Private Lenders' Responsibilities in Times of Crisis

by

Sungsoo Koh

1. Introduction

Since the Asian financial crisis, many studies have discussed the role of financial institutions and bankruptcy procedures in improving the efficiency of both domestic and international capital markets. This is partly because the nature of financial crises has changed. Recent crises in Asian countries were generated by very large capital account movements, whereas in the past crises resulted from current account imbalances. In addition, the financial support made available to countries through the IMF allows the so-called moral hazard problem to take root by encouraging investors to take excessive risks. This was evident in the severe compression in spreads and apparent neglect of due diligence in lending to some Asian countries.

Efforts to alter the behavior of private investors are also warranted by the tendency of investors to display "herd" behavior, including "creditor runs." The enormous stock of foreign liabilities in many countries means that a loss of financial market confidence, whether resulting from a deterioration in underlying economic conditions or simply creditor panic, can precipitate a major external crisis. In these cases, the official resources required to address countries' external imbalances could be very large, possibly straining the resources of the international community.

The changing nature of financial crises necessitates different approaches by the official sector, which now requires more effective financial supervision and regulation, further capital account liberalization, and improved transparency in both the public and private sectors. In addition, there is a growing consensus on the need to strengthen the mechanisms for involving the private sector in crisis prevention and resolution. This consensus is based on the understanding that inappropriate incentives and misleading

information that faced the private sector, as well as economic policy failures, were major contributors to recent crises.

Studies on bankruptcy procedures to bailout creditors already exist. Such procedures are necessary, because unpaid creditors would otherwise be an obstacle to restructuring an economically viable but insolvent corporation. However, while bankruptcy is a usual way to represent the financial difficulties of individual firms during the normal time, even efficient systems are likely to be rapidly overwhelmed in periods of widespread financial crisis. In these cases, alternative informal mechanisms, such as the so-called London Approach and the Jakarta Initiative, are likely to be required.

Under the London Approach, developed by the Bank of England, authorities use their influence to set in motion a restructuring process, the success of which will rely on adherence to certain collective action principles, none of which are legally binding. On the other hand, the Jakarta Initiative provided a legal and regulatory framework, supported by a coordinating task force, as a basis for decentralized corporate restructuring subject to an agreed set of basic principles.

Similar efforts have been made by the Korean government, domestically and internationally. After the financial crisis, the Korean government first tried to solve the problem of foreign liabilities. Korea's external debt consisted primarily of bank loans rather than bonds or other securities. A concerted rollover and restructuring of inter-bank credit lines provided a much needed breathing space, and proved to be an effective means of stopping capital outflows in Korea. Short-term, cross-border inter-bank credit lines were a source of particularly acute balance of payments pressures preceding the Korean crisis. Against the background of hemorrhaging official reserves and the prospect of an imminent default, the concerted rollover of short-term bank credit was successful in stabilizing a critical situation and facilitating a transfer of inter-bank claims into sovereign guaranteed bonds. Accordingly, concerted debt restructuring by international private investors and the Korean government's guarantee of banks' debts successfully stabilized the international turmoil.

On the domestic side, the Korean government has focused mainly on resolving the bad loan problems at financial institutions and restructuring corporate debt structures. As the government is responsible for the licensing and supervision of financial institutions, it has significant leverage to facilitate financial sector restructuring. On the

other hand, corporate restructuring is to be pursued on the basis of market principles with minimal government involvement. The speed of corporate restructuring will therefore be slower than that of the financial sector. It is partly because excessive and direct government involvement in corporate restructuring is not desirable in a market-oriented economy. The government continues to exert efforts toward improving the legal and institutional environment. The Korean government proposed an agreement between financial institutions and large corporations to facilitate the debt restructuring of financially distressed firms. Under this agreement, which can be considered as a modified version of the London Approach, the government established fair loss-sharing practices that encourage firms, the government and creditors to equitably share losses from corporate restructuring. To encourage compliance by domestic financial institutions, the Korean government uses moral persuasion to emphasize the role of financial institutions in corporate restructuring.

This paper describes the role of financial institutions in restructuring financially distressed firms and summarizes recent proposals on this issue in times of financial crisis. The next section will present a brief survey of academic studies on the topic. A simple model describing the role of financial institutions in corporate workout programs is introduced in section 3. In section 4, I describe the corporate restructuring process in the Korean case, and the discussion concludes in section 5.

2. Studies on the Responsibilities of Lenders

The role of financial institutions in reducing bankruptcy costs has been a popular topic for many economists. In theory, as long as a firm has good prospects, financial distress would have no real impact, since the firm's debt will be renegotiated to ensure its survival. However, in the real world, conflicting claims of creditors make renegotiations difficult and may induce creditors to liquidate the firm even though it is not collectively optimal to do so.

The costs of financial distress stem from the inherent difficulty of renegotiating financial claims when there are many creditors, particularly in times of crisis. Free-rider problems reduce the incentive for creditors to grant financial relief through the infusion of new money or restructuring debt structures of borrowers.

It is necessary to negotiate with all parties simultaneously when there are many creditors, especially in time of crisis. Holdout creditors could otherwise free-ride on others. As discussed by Myers (1977), Bulow and Shoven (1978), and Gertner and Scharfstein (1990), difficulties in negotiating with creditors may lead to underinvestment and inefficient liquidation. Even if the firm has valuable investment opportunities, an individual creditor may be reluctant to finance them because a part of the improved future cash flows accrue to holdout creditors. In other words, even if it is efficient for creditors collectively to write down the debt, a sole creditor may be unwilling to do so because he will bear the total cost and receive only part of the benefit.

These problems are exacerbated when creditors are not well informed about the firm's prospects. In this case it is difficult to raise capital from one creditor, let alone persuade numerous creditors to agree to a financial restructuring that promotes investment and avoids inefficient liquidation. Hoshi et al (1990) present empirical evidence that the close relationship between financial institutions and firms lessens the cost of financial distress in the Japanese financial market. The bank system in Japan encourages banks to monitor debtors and their prospects closely, and thus problems stemming from asymmetric information between creditors and firms are likely to be small. When financial claims are spread among many creditors, financial distress is more costly than

when claims are concentrated. Reducing the costs of financial distress facilitates investment and relaxes liquidity constraints even when firms are not distressed. In Hoshi et al's paper, the main bank and largest shareholder plays an important role in mitigating the bankruptcy cost.

A less obvious reason why the Japanese system is less prone to free-rider problems stems from the repeated participation of banks in lending consortiums, e.g. a syndicated bank loan. It is clear to all members of the consortium that the main bank is responsible for helping the firm in times of distress. Repeated participation in these consortiums ensures that the main bank fulfills its implicit contract to provide relief even though doing so may not seem best in the short run. As Allen (1985) points out, an infinite time horizon increases the chances that the best option will be chosen. If a principal-agent relationship is repeated, then it is possible to statistically test whether the actual distribution of output is the same as the distribution of output corresponding to the agent's initial best solution. As the number of repetitions increases, these tests become more powerful. Thus repeated participation of financial institutions in lending consortiums encourages the positive role of lenders in resolving financial distress.

In this scheme, Hunn (1996) discusses the role of bank syndicate agents in workouts. He points out that the credibility and moral authority of large banks in the US crashed after the mid-1970s REITs crisis under the banner of "all play no play." In bankruptcy, the leading bank syndicate agent faces challenges not only from the borrower but also from syndicate members, corporate stakeholders, and other parties to the case. In his paper, Hunn cited the role of the syndicate agent from 'Guidelines for Agented Credits' by *Robert Morris Associates*. In the guidelines, a syndicate agent should serve as the informational channel between the borrower and syndicate banks, while ensuring that these banks reach timely decisions that are communicated to the borrower's management in a clear manner.

In assuming the agent role, the bank must weigh the risk/reward trade-off of earning a fee, knowing the borrower's management and operations closely, and the vulnerability to litigation from the borrower or syndicate members for acts of commission or, more likely, omission. In the course of such litigation, the syndicate agent may be indicted for "gross negligence or willful misconduct." Thereby, the agent must undergo a global debt audit, showing all private and public financial exposure, contingent as well as

direct. If there is a significant non-syndicate financial institution debt, a standstill agreement dealing with the timing issues of a breathing space on adjustments to principal, interest rates, and/or collateral claims should be considered.

In addition, if the group is large, the syndicate agent should supervise committees of representative lenders as well as audit and cash control committees. Another agent responsibility is to develop recommendations for professional advisers, such as lawyers, accountants, investment bankers, and consultants, for the syndicate and the borrower. If the lending group is large, the agent should establish a communication network and facilitate the communication between the syndicate and the borrower.

In time of financial distress, the agent must play an important role. In conjunction with the steering committee and professional advisers, the agent must collaborate with other parties to design the future strategy: an achievable financial plan. The agent must hold the bank group to the criteria of rehabilitation: viability, an achievable business plan, and a responsible, communicative management system. In relationships with management, the agent should make a thoughtful effort to develop important contacts.

To avoid a free rider problem, the banks should not undertake rehabilitation by themselves. Rather, a workout requires a loss sharing approach by all of the borrower's constituencies. As a practical matter, the fiduciary concerns are seldom burdensome, because parties expect committee members to have their individual interests in mind.

Recently, a lender's legal liability regarding requests for credit information has attracted public attention. Tenenbaum and Treger (1996) encourage lenders to behave responsibly by suggesting guidelines to avoid litigation related to credit inquiries. They suggest that a bank should not, even unintentionally or negligently, provide the inquirer with credit information that is incomplete, incorrect, or misleading.

According to the academic studies, the responsibilities of private lenders can be summarized as follows. Private lenders should monitor borrowers closely before and after the loan agreement is made, and should provide correct information on credit history of borrowers. In addition, they have to participate actively in workouts of financially distressed borrowers with positive NPV projects in order to avoid economically inefficient underinvestment.

3. A Model

In this section, a simple model of a financially distressed firm is considered. The model described in this section is a modified version, or a reinterpretation, of Gertner & Scharfstein (1991). A firm is provided with credits by two types of lenders, cooperative lenders and non-cooperative lenders. We think of the cooperative lenders as commercial banks and the non-cooperative lenders as public debt-holders, reflecting the idea that it is easier to renegotiate with banks (or large institutional creditors) than with numerous public debt-holders. To make the discussion simple, let's assume that the firm cannot renegotiate with public debt-holders for the moment.

The bank loans, face value B , mature at date 1 and fraction q of the face value of the public debt, D , is due at date 1. The rest of public debt matures at date 2.¹ At date 1, the firm has cash Y and an investment project, which requires I to undertake. We denote the cash flow of X at date 2 distributed over the support of $[0, \infty)$. The cumulative distribution of X is $F(X)$, while the density is $f(X)$, and the expected value of X is $E(X)$. All players in this model are assumed to be risk neutral, and the risk free interest rate is zero. The firm has no fixed assets.

At date 1, the firm is financially distressed, i.e. $Y < B + qD$. The firm cannot repay the debt due at date 1. Thus, if the firm is liquidated, absolute priority rules are followed and shareholders receive zero. If we assume that all debts are of equal priority, then public debt-holders and banks share Y . Then banks get $\left(\frac{B}{B+D}\right)Y = L_B$ and debt-holders get $\left(\frac{D}{B+D}\right)Y = L_D$.

If the financially distressed firm invests in the project at date 1, the firm needs an additional $(I + B + qD - Y)$. The investment is beneficial to shareholders of the firm since there is the possibility of a positive return; otherwise shareholders get zero. However, the firm does not have enough funds to invest, i.e. $Y < I + B + qD$, so the firm has the option of issuing debt or equity, or restructuring debts. We simply exclude the option of issuing debt or equity as it is not easy for the financially distressed firm to

¹. The rationale of setting different maturity for non-cooperative lenders reflects the fact that cooperative

raise funds in the financial market. This is especially true when the economy is in a crisis.

If the banks (large creditors) find bank debt restructuring for the firm profitable, the firm effectively rolls over its initial loan of B and borrows an additional $(I + qD - Y)$ for the investment and the payment of the public debt due at date 1. We assume that the interest on debt has lower priority than all outstanding debt, while the principal has equal priority. If we assume that the new interest has lower priority, the combined return to the bank and the firm is independent of the interest rate.

If the firm invests and $X < I + B + D - Y$, banks receive $\frac{I + B + qD - Y}{I + B + D - Y} X$ at date 2,

where $(I + qD - Y)$ is an additional loan to the firm and B is an old debt. If $X > I + B + D - Y$, shareholders and banks together get to split $[X - (1 - q)D]$. Thus, if the expected payoffs to banks at date 2 are greater than the amount that banks can get in liquidation, banks voluntarily restructure the firm's debt. The condition for the banks to restructure the debt can be denoted as follows.

$$\int_0^Z \frac{I + B + qD - Y}{I + B + D - Y} X f(X) dX + \int_Z^\infty [X - (1 - q)D] f(x) dx - (I + qD - Y) \geq L_B \quad (1)$$

,where $Z \equiv I + B + D - Y$

If we rewrite the equation (1),

$$E(X) - I \geq qD + \int_0^Z \frac{(1 - q)D}{Z} X f(X) dX + \int_Z^\infty (1 - q)D \cdot f(x) dx + L_B - Y. \quad (2)$$

The first three terms on the right hand side represent the value of debts that are not restructured. Then we can rewrite equation (2) as follows,

$$E(X) - I \geq V_D - L_D \quad (3)$$

,since $Y - L_B = L_D$.

lenders are assumed to participate in the debt restructuring without consideration of their maturity.

The inequality (3) shows the condition for cooperative lenders to provide the firm with fresh funds. The left-hand side of the inequality is the NPV of the new investment and the right-hand side of the inequality is the size of the transfer from the cooperative lenders, banks, and shareholders to non-cooperative lenders. If the transfer from the cooperative lenders has the positive value, $V_D - L_D > 0$, the new debt obligation acts as a tax on the project, which discourages the investment. This is a typical free rider problem. If some lenders forgive part of their debt, the value of remaining debt rises.

If the NPV of the project is negative, i.e. $V_D - L_D < 0$, $V_D - L_D < NPV < 0$, then the cooperative creditors, banks, effectively subsidize the firm, encouraging the investment. However, this can result in overinvestment, as suggested by Jensen and Mecking (1976). In addition, the underinvestment problem exists when the NPV of the project is positive since the transfer to the non-cooperative lenders discourages the injection of new money by cooperative lenders.

Accordingly, the investment decision for the financially distressed firm, especially with non-cooperative or diffused lenders, is very difficult. The investment is also dependent upon the condition of the firm at date 1. If the firm is in significant trouble, i.e. Y is close to zero, the liquidation value of the firm, L_D and L_B , is worth almost nothing. Then non-cooperative lenders, such as public debt holders, are more likely to benefit from the investment, while the cooperative lenders' payoffs are dependent on the size of the transfer in inequality (3). This free-rider problem discourages the investment, resulting in underinvestment suggested by Myers (1977).

The maturity structure of the debt also has important effects on the efficiency of investment. As the portion of non-cooperative lenders at date 1 becomes large, the total value of non-cooperative lenders' debt increases, $\frac{dV_D}{dq} > 0$. This increases the

transfer to public debt-holders from cooperative lenders and shareholders and the firm would pass up positive NPV, resulting in a decrease in the firm's incentive to invest.

If all of a firm's debts are held by cooperative lenders, the positive investment would always be efficient. If the firm has a positive NPV project and there is an effective agreement among the lenders, or legal/official framework to enforce the agreement, the

cooperative action produces a better outcome. If the cooperation amongst lenders, for instance the standstill or the automatic stay in Chapter 11, is effective, it extends the maturity of the public debt, i.e. from $q > 0$ to $q = 0$. Thus, this increases the firm's incentive to invest, as we have seen. The investment will be made not only when the firm has enough cash for the investment, $I + B < Y < I + B + qD$, but also when the firm must borrow, $Y < I + B$. This is because the standstill agreement effective from date 1 to date 2 forces public debt-holders to bear more risk. In this situation, overinvestment may occur, but oversight by the court or the supervisory authority and the ability of public debt-holders to object to the firm's investment can prevent an ineffective investment.

As q approaches zero, we can rewrite inequality (1) as follows,

$$\int_0^Z \frac{I+B-Y}{I+B+D-Y} X f(X) dX + \int_Z^\infty [X-D] f(x) dx - (I-Y) \geq L_B \quad (1)'$$

,where $Z \equiv I + B + D - Y$.

And inequality (2) becomes

$$E(X) - I \geq \int_0^Z \frac{D}{Z} X f(X) dX + \int_Z^\infty D f(x) dx + L_B - Y. \quad (2)'$$

In this case, the first two terms on the right hand side represent the value of debts under the new standstill agreement. Then the value of non-cooperative debt can be defined as,

$$V_D' \equiv \int_0^Z \frac{D}{Z} X f(X) dX + \int_Z^\infty D f(x) dx$$

By comparing inequality (2) and (2)', the transfer to non-cooperative lenders is lessened, since $V_D' < V_D$. In addition, cooperative lenders' additional exposure to the financially distressed firm can be decreased from $(I + B + qD - Y)$ to $(I + B - Y)$, while

the expected payoffs are the same as before, which facilitates cooperative action among lenders. Finally, this cooperative action increases the chance of investing in the positive NPV project and the free-rider problem can be mitigated.

The priority of debts is not dealt with much in the model. If we introduce the priority issue of new financing into the model, the model becomes more complicated, but more realistic. When the non-cooperative debt is short term, the cooperative debt is senior and the non-cooperative debt is protected by seniority covenants, then underinvestment is likely to be a problem. When investment is risky relative to continuation, investment tends to be more attractive to the bank than equity because the public debt is worth less. Cooperative actions among lenders promote investment rather than give the firm an easy way of avoiding efficient liquidation. Thereby it is very important to design an incentive mechanism that induces cooperative actions among lenders. Various suggestions on this issue have recently been proposed in many areas of global financial markets. Designing a costly bankruptcy procedure is one attempt to solve the underinvestment problem. If bankruptcy proceedings are costly, public debt holders may choose not to force the firm into bankruptcy despite default. In the case that there are too many diffused small lenders, debtors can offer the holders of the public debt a claim just above its liquidation value, so there is no subsidy to or from public debt holders.

Restructuring the debt of a financially distressed firm with different types of lenders is not an easy task. It produces a typical prisoner dilemma problem. If one type of lender, cooperative players, agrees on new financing and the other type does not, the one who agrees to grant relief will end up transferring their wealth. Thereby debt restructuring may not be a Nash equilibrium in the short run, though it might be Pareto optimal in the long run. The workout process also increases social welfare in the short run and is beneficial to the participants in the long run.

In addition, the workout process is especially beneficial to a financial institution concerned about its reputation in the financial sector. Large financial institutions with good reputation in the global financial sector in particular have the responsibility of stabilizing financial markets, since many small institutions follow their decisions. The Japan Development Bank (JDB), for example, provides important information to the

Japanese financial sector.² When the JDB lends to a firm, that firm is regarded as a company with good prospects, and it can easily obtain funds in the financial market. Thus, a financial institution with a good reputation has the responsibility to practice sound asset management in the financial market. The large institutional investor should be cautious when it grants a loan to certain borrowers. In addition, the financial institution should monitor the borrower properly. As long as the borrower is being financed by large financial institutions, other small investors will also continue to lend to the borrower. If the large institution stops providing funds to the borrower, small investors are rapidly withdraw funds, resulting in financial trouble.

As described in the model, debt restructuring for the financially distressed firm is not a zero-sum type of game. If the game is splitting a pie of a given size, it is difficult to design a mechanism to make one group of lenders quietly accept their losses. But if the game involves splitting a growing pie, it is much easier to induce coordination as long as each player's payoff is not lessened.

² . See Horiuchi, A. and Q. Sui (1993), "Influence of the Japan Development Bank Loans on Corporate Investment Behavior," Working Paper 93-F-4, University of Tokyo, for details.

4. Korean Experience

Korea has been undergoing its worst economic depression since the Korean War. Although the current crisis was initially triggered by a depletion of foreign exchange reserves, it is widely believed that the structural weaknesses of the Korean economy eventually brought about the crisis. Most notably, the fragile financial sector failed to keep up with the fast growing economy that became increasingly open and integrated into the world financial system. Moreover, outdated systems of corporate governance and a high leverage ratio, together with a fragile banking system, left the corporate sector particularly vulnerable to external shocks and high interest rates.

Since the onset of the crisis, the Korean government has been trying to restore market confidence by restructuring both the financial and corporate sectors. As the government is responsible for the licensing and supervision of financial institutions, it has significant leverage to facilitate financial sector restructuring. On the other hand, corporate restructuring is to be pursued on the basis of market principles with minimal government involvement. It is partly because excessive and direct government involvement in corporate restructuring is not desirable in a market-oriented economy. The government continues to exert efforts toward improving the legal and institutional environment to facilitate corporate restructuring.

The objectives of restructuring the Korean corporate sector are twofold. The first objective is the reduction of corporate debt, while the second involves improving management transparency and corporate governance structure. As discussed earlier, the government is refraining from direct intervention in corporate restructuring. In this respect, financial institutions assume an even bigger role in corporate restructuring as both major players and monitors. The government will encourage the financial sector to expedite its restructuring efforts by providing funds for recapitalization and the purchase of non-performing loans. Financial restructuring will help corporate sector reform by easing liquidity constraints and enhancing monitoring.

The government shares its role as director of restructuring with financial institutions, the lenders. Major creditors will take the leading role in implementing corporate restructuring policy. For this purpose, creditors and debtors, especially the largest sixty-

four *chaebols*, signed capital structure improvement plans (CSIPs). As the top five *chaebols* are believed to have sufficient capacity to absorb losses, while small firms are too weak to take on any additional financial burdens, the government advised major banks to take on a leading role in restructuring the top 6-64 conglomerates.

The top 6-64 *chaebols* and other large firms do not possess the capacity to pursue restructuring on their own in times of financial crisis. Because they maintain affiliations with multiple creditors, this group of firms is subject to workout programs directed by their largest creditor. The workout programs involve close consultation within the creditor group. In order to facilitate corporate restructuring, the government established a rule of *fair loss-sharing*. The fair loss sharing practice urges the firm, the government and creditors to share losses involved in corporate restructuring equitably. While leading financial institutions pursue corporate restructuring efforts through various measures, the government helps improve banks' capacity to help firms by disposing of non-performing loans and providing financial support for M&As.

Workout programs should be regarded as a voluntary course of action undertaken by financial institutions to minimize their losses, and not as an unwilling sacrifice on the part of the creditor financial institution. Thus support and loss sharing borne by financial institutions for a viable firm should not be thought of as preferential treatment, but rather as the option best in line with creditors' own interests of enhancing profits, as described in the model in the previous section.

Firms as well as creditors involved in workout programs must assume responsibility and share losses. In accordance with fair loss sharing practices, however, the firm is not made to bear the entire burden. If financial institutions assume a significant burden, then they can be compensated with some stake in the firm. In the case of capital reduction, the dilution of major shareholders could be resolved if the financial institutions offer buy-back options after a certain period passes.

A 'Corporate Restructuring Agreement (CRA)' was signed by 210 financial institutions on July 25, 1998 to effectively coordinate diverse interests among creditor institutions. Workouts are carried out in accordance with procedures laid out in the CRA. In cases where creditor councils are unable to reach agreement on a workout plan, arbitration is provided by the 'Corporate Restructuring Coordination Committee, CRCC), which was set up in accordance with CRA provisions.

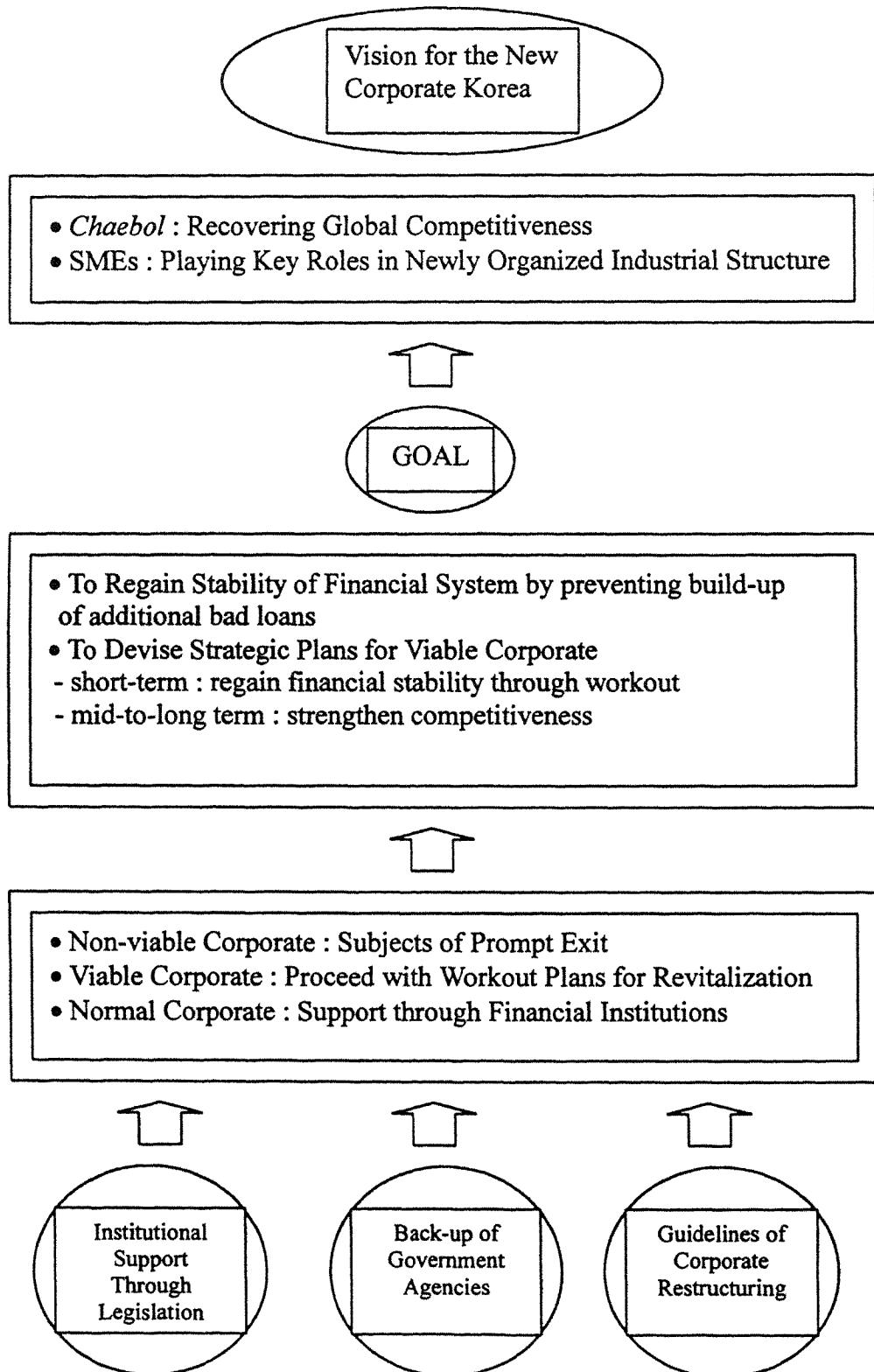
Generally, a workout refers to the process of developing rehabilitation plans for financially distressed firms with positive prospects through a series of negotiations involving various stakeholders, including creditor financial institutions and firms. As a workout is designed to return profitability to viable firms, it is much more effective than placing the firm into legal receivership. Measures taken for debt restructuring include but are not limited to, debt-equity conversion, term extension, deferred payment of principal or interest, interest rate cut, waiver of indebtedness, provision of new credits, cancellation of existing guarantee obligations, etc.

During the course of a workout, creditors receive influence in proportion to their claims. Loss sharing should also be equitable when restructuring the debt of a given firm. It is the responsibility of the leading creditor to maintain all information related to the workout process and make it available to all creditors. The leading creditor should maintain a sense of balance throughout the workout process, providing direction but not being overbearing. It will not dominate the negotiations but rather act as a mediator in any conflicts of interests that may arise. Although decisions for workouts are doubtless complex and difficult, agreement within a reasonable time frame is necessary to avoid unnecessary costs associated with delay.

As of March 10, 1999, 83 firms were undergoing workout procedures in accordance with CRA provisions. Of these 83, 72 firms' rehabilitation plans are settled. Sixty-three plans were settled by mutual agreement between borrowers and lenders, and 9 plans required arbitration by the CRCC. The remaining 11 firms are either involved in consultations with creditors or arbitration by the CRCC. By the end of 1998, debts of 23.7 trillion won had been restructured, and fresh funds amounting to 1.6 trillion won had been injected into troubled firms. Details are presented in the following table.

It is too early to evaluate the workout process under the CRA provisions in Korea. However, the ability to resolve the complexities of diffused lenders is recognized as a success considering Korean financing behavior. As the government is currently pushing financial institutions to actively proceed with the workouts, more successful results can be expected.

<Figure1> Vision of the Korean government for Corporate Restructuring



<Table 1>**Workout Progress in Korea**

(as of Dec. 31, 1998)

(unit: trillion won)

Debt Restructuring	23.7
interest rate cut	16.8
deferred payment of interest	3.6
waiver of indebtedness	0.6
convertible bond	1.7
debt/equity conversion	1.1
Provision of New Credits	1.6
operating funds	1.0
trade related	0.6
<i>Total</i>	<i>25.3</i>

5. Concluding Remarks

The responsibilities of private lenders discussed in this paper focus mostly on the management of debts after loan contracts. Lenders, especially large stakeholders, should monitor borrowers and their projects properly before and after the loan agreement is made. In addition, the institutional lenders have the legal obligation to provide the right information on credit inquiries for borrowers. As discussed by Hunn (1996), the standard language of loan agreements is to grant the agent exculpation except for “gross negligence or willful misconduct.” In a study of bank syndicate agents’ roles in workouts, the syndicate banks sued on the following grounds: breach of the agreement terms, breach of fiduciary duties, common-law fraud, and violations of federal and state securities laws.

In order to prevent undesirable litigation, the agent should monitor borrowers closely, including all private and public financial exposure, contingent as well as direct. If there are diffused lenders with conflicting interests, a standstill agreement dealing with the timing for a breathing space on debt restructuring should be considered. The agent is responsible for organizing creditor-debtor councils to improve the flow of information. Another agent responsibility is to develop recommendations for professional advisers, such as lawyers, accountants, investment bankers, and consultants, for the syndicate and the borrower.

In times of trouble, the agent must play an active role in resolving problems of a financially distressed firm. The banks should not undertake rehabilitation alone. On the contrary, the agent should induce related lenders to cooperate in workouts for viable firms through a ‘*fair loss sharing*’ approach. As described in the model, cooperative actions among lenders result in more efficient investments, while the payoffs to all participants are greater than the payoffs in liquidation. This is effective as long as the firm in trouble has positive NPV projects, a case where the pie is growing. In the case of positive NPV projects, collective action brings about economically and socially desirable results.

Similar to the London Approach, Korean workouts under the CRA are currently in progress in order to lessen the bankruptcies of viable firms in the midst of the severe

financial crisis. The Korean government is not directly involved in the program, and instead acts as a mediator or guide. Even though the results of the workouts are no longer reported as in the beginning stages, the collective actions agreed upon so far are very impressive given the difficult situation in Korea. Accordingly, the importance of legal provisions or collective agreement among financial institutions for cooperative actions is key in reducing bankruptcy costs and underinvestment.

Unlike in domestic financial markets, it is not easy in the international financial market to design a system for private lenders to voluntarily participate in workouts of financially distressed firms. More needs to be done to create incentives and instruments for the private sector to remain involved. As directors in the IMF agree, there is no silver bullet to ensure that private creditors will fully participate in the resolution of financial crises.

Recently a number of interesting proposals have centered on the issue of *ex ante* measures that can be designed and put into place before the event. These relate to the question of whether it is possible to develop mechanisms that effectively induce private lenders to maintain or provide additional net exposure, or at a minimum reduce debt service burdens in times of crisis, while simultaneously limiting moral hazard and market distortion in normal times. Among them, a concerted rollover and restructuring of interbank credit lines is suggested, which would effectively provide a breathing space. This method proved to be an effective means of stanching capital outflows in Korea. Even though the Korean case cannot easily be extended, it is worthy of rigorous study. As the G-22 Working Group recommended, incorporating Collective Action Clauses into bond contracts could facilitate debt holders' decisions, and prevent dissident shareholders from blocking a debt restructuring acceptable to the vast majority of debt holders.

Another approach would be to design bankruptcy procedures for corporations that help to improve the efficiency of capital markets by addressing the financial difficulties of individual corporations. If countries in the global financial market had efficient bankruptcy procedures or practices, it would be much easier to induce collective action in the international market. In order to establish a new system, the importance of maintaining effective communication between borrowers and private capital markets is essential. Thus, creditor-debtor councils are recommended to improve the flow of

information. Implementing monitoring systems for borrowers during normal times would help avoid dangers of adverse market reactions during periods of financial crisis and would provide authorities with an additional tool to strengthen economic management in the context of closer integration with global capital markets.

As discussed earlier, it is not an easy task to persuade private lenders to agree on collective action for workouts in the global market. Moral persuasion for large reputable financial institutions would be one way, so that institutions that cared about their international reputation would voluntarily participate. More efforts should be made to enhance the credibility and moral authority of international financial institutions. However the discussion should not encourage sacrifice for just one group of lenders. As in the Korean CRA approach, a fair loss-sharing rule should be established. More studies on this topic would be helpful.

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Fiscal Dimensions - Selective Observations

Professor Christopher H. Hanna

MEMORANDUM

Professor Christopher H. Hanna

Brief Summary of Presentation at the University of Hong Kong

There are three theories that are of overwhelming importance in developing an ideal income tax system. In my opinion, these three theories are the only ones that tax theorists, politicians, and bureaucrats need to know in setting up an ideal income tax system. Of course, practical problems may arise such as valuation, administration, liquidity, constitutional, and political problems. These practical problems need to be weighed against the three theories in actually implementing an income tax system.

The first theory was developed by Robert Haig in 1921 and refined by Henry Simons in 1938. It is generally referred to as the Haig-Simons definition of income. This definition provides that income is the algebraic sum of consumption plus the net change in the value of assets for the period in question. Most tax theorists agree that it is ideal definition of income. One of the major impediments to implementing this definition is the realization doctrine. For example, an individual who owns appreciated stock is not taxed on that appreciation until the individual sells the stock. Under the Haig-Simons definition of income, the appreciation that occurs each year is included in income, and the individual must pay taxes on that amount. This is a dramatic departure from our current income tax system. However, with the increasing use of derivatives, our income tax system may soon be forced to abandon the realization doctrine in certain circumstances and implement the Haig-Simons definition of income.

The second theory was developed by MIT economics professor Paul Samuelson in 1964. It is generally referred to as economic depreciation or Samuelson depreciation. Under this theory, the proper measurement of depreciation for a particular asset is the decline in value of that asset. The decline can be measured by determining the present value of the cash flows that the equipment will generate in the future. The present value of the cash flows at the beginning of the period in question minus the present value of the cash flows at the end of the period represents the decline in the value of the equipment. Samuelson depreciation should be used whenever time value of money concepts are applicable.

The third theory was developed by MIT economics professor E. Cary Brown in 1948. Under this theory, immediately deducting the cost of an asset is equivalent to excluding the future annual return of the asset from income. For example, assuming

stable tax rates and investment yields, the tax deferral benefit of investing in a retirement plan that provides a deduction for contributions and full taxation of distributions is equivalent to investing in a retirement plan that provides no deduction for contributions and non-taxability of distributions.

I. Introduction

Tax scholars have developed a number of theories over the years with respect to an ideal income tax system. These theories seem to be more important than ever, particularly with the increasing use of derivatives and financial instruments in business transactions. As Professor Alvin Warren noted six years ago, “innovative financial contracts provide a serious challenge to an income tax based on realization, even in the simplest case of purely domestic transactions without special treatment for capital gains and losses.”¹

It appears that in developing an ideal income tax system, three theories are of overwhelming importance. These three theories are the Haig-Simons definition of income, the Cary Brown model, and Samuelson depreciation. In this paper, I will discuss the history behind each theory and demonstrate an application of the theory. It should be noted that while these three theories are the most critical in setting up an ideal income tax system, complying with them may not be feasible in all cases. Issues of practicality, administrability, and political and constitutional problems may arise in establishing an ideal income tax system. As a result, these issues must be weighed against implementation of the three theories.

II. The Haig-Simons Definition of Income

The Haig-Simons definition of income is generally considered by most tax scholars to be the ideal definition of income. It is sometimes referred to as the Schanz-Haig-Simons definition of income, reflecting the early contribution of Georg von Schanz.² This definition is the

¹ Alvin C. Warren, “Financial Contract Innovation and Income Tax Policy,” 107 Harv. L. Rev. 460, 461 (1993).

² Georg von Schanz, “Der Einkommensbegriff und die Einkommensteuergesetze,” Finanz-Archiv, vol. 13, no. 1 (1896), pp. 1-87.

accretion concept of income, which defines income as the sum of consumption and accumulation. Robert Haig published his definition of income in 1921.³ Haig wrote that income is “the increase or accretion in one's power to satisfy his wants in a given period in so far as that power consists of (a) money itself, or, (b) anything susceptible of valuation in terms of money. More simply stated, the definition of income which the economist offers is this: Income is the *money value of the net accretion to one's economic power between two points of time.*”⁴ Haig focused on the point in time when the power to satisfy one's wants is increased, not necessarily the point in time when the wants are actually satisfied.⁵ As a result, Haig included savings in income even though it had not been consumed yet.

Henry Simons published his definition of income in 1938. Simon's definition is considered a refinement of Haig's definition, and it is Simon's definition that is often cited today. Simons wrote that income is the “algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question.”⁶ Simons also noted that “[I]n other words, it [income] is merely the result obtained by adding consumption during the period to ‘wealth’ at the end of the period and then subtracting ‘wealth’ at the beginning.”⁷

Probably, the single largest violation of the Haig-Simons definition of income is the realization doctrine. Under the realization doctrine, appreciation in property is not taxed until the property is sold or otherwise disposed of. For example, assume an individual owns publicly

3 Robert M. Haig, “The Concept of Income -- Economic and Legal Aspects,” in *The Federal Income Tax* (Robert M. Haig ed., 1921).

4 *Id.* at 7.

5 See Stanley S. Surrey et al., *Federal Income Taxation* 61 (1986).

6 Henry C. Simons, *Personal Income Taxation* 50 (1938).

7 *Id.*

traded stock that has appreciated in value. Under a realization based income tax system, the individual will defer paying taxes on the appreciation until a realization event, most likely a sale, takes place. As a result, much of the wealth of Bill Gates and Warren Buffet has never been taxed because, in each case, the bulk of their wealth is held in stock of corporations they created, Microsoft and Berkshire Hathaway, respectively. Professor William Andrews refers to the realization doctrine as the “Achilles' heel” of the income tax system, in large part, because of the tax deferral benefit of the realization doctrine. A leading practitioner has noted that “so long as we continue under a realization system of tax accounting, it is not possible to achieve an equivalent tax treatment of economically equivalent financial investments.”⁸

Probably, the most discussed method for eliminating the tax deferral benefit of the realization doctrine is a mark-to-market method of accounting. Most agree that it is a theoretically correct approach in an ideal income tax system. In other words, it implements the Haig-Simons definition of income, which most tax theorists feel is the ideal definition of income. As many commentators have noted, however, eliminating the realization requirement and adopting a mark-to-market approach for unrealized appreciation in property could lead to numerous problems. These problems include liquidity in paying the resulting income tax, administrability in determining the changes in fair market value of the taxpayer's assets (particularly those not traded on a publicly traded exchange), and possible constitutional (or political) problems. It appears, however, that a strong argument could be made to partially or completely repeal the realization doctrine at least as to publicly traded property where problems of liquidity and valuation generally are not present.

⁸ David P. Hariton, “The Accrual of Interest on Derivative Investments: Where Do We Go From Here?,” 74 *Taxes* 1011, 1012 (1996).

III. The Cary Brown Model

A. Introduction

The Cary Brown model, sometimes referred to as the MIT model, generally holds that immediately deducting the cost of an asset is equivalent to excluding from income the future annual return of the asset. The Cary Brown model is named after its founder, Dr. Edgar Cary Brown. Dr. Brown, an economics professor at the Massachusetts Institute of Technology, published his model as a 17-page article in 1948 in a book containing a collection of essays, *Income, Employment and Public Policy, Essays in Honor of Alvin H. Hansen*.⁹ It has been reprinted since then.¹⁰ The Cary Brown model, as it is currently understood today, is discussed in less than one and a half pages of the article.¹¹ The model will be discussed in two parts in B. and C. below.¹²

The Cary Brown model, although it has been in existence since 1948, did not seem to attract much attention in either the tax law or economic literature until the late 1960s and then throughout the 1970s.¹³ In fact, the awareness in the late 1960s seemed to be primarily by

9 See E. Cary Brown, "Business Income Taxation and Investment Incentives," in *Income, Employment and Public Policy: Essays in Honor of Alvin H. Hansen* 300, 309-310 (1948).

10 See American Economics Assn., *Readings in the Economics of Taxation* 525-37 (Richard A. Musgrave and Carl S. Shoup eds., 1959).

11 See Cary Brown, *supra* note 9, at 309-310.

12 This discussion of the Cary Brown model has been partially adapted from Christopher H. Hanna, "The Virtual Reality of Eliminating Tax Deferral," 12 *Amer. J. Tax Pol'y* 449 (1995).

13 See, e.g., Carl S. Shoup, *Public Finance* 302 (1969); Stanley S. Surrey, "The Tax Reform Act of 1969 - Tax Deferral and Tax Shelters," 12 *Bost. Coll. Ind. & Comm. L. Rev.* 307, 313 (1970); United States Treasury Department, *Tax Depreciation Policy*, 116 *Cong. Rec.* E6963-6975 (July 23, 1970); Stanley S. Surrey, *Pathways to Tax Reform* 123 (1973); William D. Andrews, "A Consumption-Type or Cash Flow Personal Income Tax," 87 *Harv. L. Rev.* 1113, 1127 (1974); Alvin C. Warren, Jr., "Fairness and a Consumption-Type or Cash-

public finance experts with a limited number of tax experts focusing on the Cary Brown model. Not until the 1970s and 1980s, did a number of tax articles appear discussing the Cary Brown model.

Much of the early awareness of the Cary Brown model may have been due to the appointment of Professor Stanley S. Surrey to the post of Assistant Secretary of the Treasury for Tax Policy in 1961 by President John F. Kennedy. Professor Surrey continued to serve as Assistant Secretary of the Treasury for Tax Policy until 1969, when he returned to the Harvard law faculty. During his tenure at the Treasury Department, Professor Surrey raised Congress' and taxpayers' awareness of the benefits of tax deferral. His tenure at Treasury culminated in the Tax Reform Act of 1969, a large tax reform package that began to seriously address issues of tax deferral.¹⁴ The awareness of the benefits of tax deferral increased during the late 1970s and early 1980s, partly as a consequence of the persistence of high interest rates.¹⁵

Professor William Andrews should also be given credit for developing interest in the Cary Brown model among American tax academics. In 1974, Professor Andrews wrote what some scholars consider to be the finest tax article in the American legal literature.¹⁶ In the article, he discussed the time value of money benefit of tax deferral and spent a substantial

Flow Personal Income Tax," 88 Harv. L. Rev. 931 (1975); Institute for Fiscal Studies, *The Structure and Reform of Direct Taxation: Report of a Committee Chaired by Professor J. E. Meade* 37 (United Kingdom 1978); Michael J. Graetz, "Implementing a Progressive Consumption Tax," 92 Harv. L. Rev. 1575, 1602 (1979).

For an earlier work by a public finance scholar, see Richard A. Musgrave, *The Theory of Public Finance* 262-67 (1959).

¹⁴ Pub. L. No. 91-172 (1969).

¹⁵ See generally Lawrence Lokken, "The Time Value of Money Rules," 42 Tax L. Rev. 1 (1986).

portion of the article discussing the Cary Brown model and its importance to understanding tax deferral.

During the 1980s and 1990s, a number of articles have appeared in the American tax literature discussing the Cary Brown model. Unfortunately, much of it has focused on its application to expensing and depreciation and very little to its application to other areas of the income tax laws, for example, prepaid income and installment sales. This is unfortunate because the model can be applied to an almost endless number of areas of the income tax laws. In fact, one leading American tax commentator has remarked that all or almost all of the time value of money provisions in the income tax laws can be described through the Cary Brown model.¹⁷

As stated previously, parts B. and C. of this article will discuss the model in two parts. The Cary Brown model can be applied not only to the deduction side, where it has traditionally applied, but also to the income side, for example, to unrealized appreciation.

B. Present Value of Tax Savings

¹⁶ See Andrews, *supra* note 13.

¹⁷ See Interview with Martin D. Ginsburg, Professor of Law, 12 ABA Section of Taxation Newsletter 6, 10 (Fall 1992) (“One of Dan Halperin’s greater achievements has been to generalize what I just described [applying the Cary Brown model to installment sales] and to show that it fairly explains almost everything in the tax law dealing with time value of money issues”).

The critical passage from the Cary Brown article is as follows:

As they [the taxpayers] telescope the depreciation deduction, the present worth of the tax rebates from the depreciation increases as the rebates are shifted closer to the present. In the limiting case, the asset could be written off in one year. In such an event, the tax rebate from depreciation would be proportional to the tax. Investment incentives would be restored to the pretax level, since the tax would proportionately reduce both the prospective net receipts from investment and its cost. By paying the entrepreneur the tax on the asset's cost, the Government would literally be a partner in the firm. It would make a capital contribution on new investments at the same rate at which it shared in the future net receipts of the enterprise. The contribution would be made at the same time the investment was undertaken. In contrast, the full-loss-offset system with economic-life depreciation would spread the Government's contribution out over the life of the investment, and would require the firm to carry a larger debt and interest cost until this contribution was finally received.¹⁸

In the above passage, the author is describing the tax effect when the cost of an asset can be spread (or recovered) over a shorter period than its economic life or, in the extreme case, be immediately deducted in computing taxable income. By shortening the period during which an asset's cost can be recovered, the present value of the tax savings is increased. For example, assume an asset used in business has an economic life of ten years. The cost of the asset is $10,000u$. If the asset is depreciated over its economic life of ten years, using straight line depreciation, and a tax rate of 40 percent, the taxpayer would have $1,000u$ of depreciation each year for ten years. This would save $400u$ in taxes each year for ten years. Using a discount rate of six percent, the present value of $400u$ each year (beginning with the current year) for ten years would be $3,120.68u$.

If, however, the asset can be depreciated over four years, then the taxpayer would have $2,500u$ of depreciation each year for four years. This would save $1,000u$ in taxes each year for four years. Using a discount rate of six percent, the present value of $1,000u$ each year (beginning with the current year) for four years would be $3,673.01u$, which is greater than the

present value of the tax savings if the asset were depreciated over ten years. This difference in present value is what Cary Brown is referring to when he states that "the present worth of the tax rebates from the depreciation increases as the rebates are shifted closer to the present."¹⁹

If the cost of an asset can be deducted immediately, or "expensed," the amount of tax saved is equal to the tax rate times the cost of the asset. In the above example, if the asset's cost of 10,000u could be deducted immediately, the taxpayer would save an immediate 4,000u in taxes. Of course, the present value of the tax savings would also be 4,000u because of the immediate deduction.

The taxpayer could take this immediate tax savings and invest it. If this additional 4,000u capital investment could also be deducted, the taxpayer would save another 1,600u in taxes, which could be invested in another deductible capital investment. By expensing the cost of the investment, the investor can increase the investment to $I/(1 - t)$, where I is the amount of income to be invested and t is the tax rate. In this case, it would be $10,000u/(1 - .40)$ equaling 16,667u.

C. Investment Incentives Returned to Pretax Level

18 See Cary Brown, *supra* note 9, at 309-310.

19 See *id.*

Expensing, or immediate deduction of an expenditure, is the classic situation to which the Cary Brown model has been applied.²⁰ Taking the above analysis one step further, expensing the cost of an asset is equivalent to exempting from income the future annual return on the asset. This is what Cary Brown is referring to when he states that "[i]nvestment incentives would be restored to the pretax level, since the tax would proportionately reduce both the prospective net receipts from investment and its cost."²¹ To illustrate this equivalence in its most basic form, assume investor A has received 16,667*u* in salary income. Assume that A is subject to tax at a 40 percent tax rate and that any tax liability is due immediately. Also assume that A has three investment options. First, she can invest in a tax-free municipal bond paying ten percent interest annually. Second, she can invest in a regular bond paying ten percent interest annually. Finally, A can invest in a regular bond paying ten percent interest annually, and the cost of the bond is immediately deductible, *i.e.*, expensed.

Under the first option, investing in a tax-free municipal bond, A will only have 10,000*u* to invest because she has to pay 6,667*u* (40 percent multiplied by 16,667*u*) in taxes on her salary income of 16,667*u*. Using a rate of return of ten percent annually, A will earn 1,000*u* of tax-free interest income each year until maturity. At maturity, A will not recognize gain or loss because her basis in the bond is 10,000*u*.

²⁰ For a thorough discussion of the Cary Brown model as it applies to expensing, see Calvin H. Johnson, "Soft Money Investing Under the Income Tax," 1989 Ill. L. Rev. 1019 (1990).

²¹ See Cary Brown, *supra* note 9, at 309-310.

Under the second option, investing in a regular bond, A again will only have 10,000u to invest because she must pay 6,667u in taxes on her salary income of 16,667u. A will earn 1,000u of interest income each year until maturity. At a 40 percent tax rate, A will pay 400u in taxes on the 1,000u of interest income leaving A with 600u in cash. At maturity, A will not recognize gain or loss because her basis in the bond is 10,000u.

Under the third option, investing in a regular bond in which the investment is deductible, A will have 16,667u to invest because the amount is fully deductible. By investing 16,667u in a deductible bond, A can utilize the deduction to offset A's salary income of 16,667u leaving A with zero taxable income at the time of the original investment. A will earn 1,667u in interest income each year until maturity (ten percent multiplied by 16,667u). At a 40 percent tax rate, A will pay 667u in taxes on the 1,667u of interest income leaving A with 1,000u in cash. By immediately deducting the cost of the bond, A will receive 1,000u after-tax each year - the exact same position A would be in by investing in a tax-free municipal bond. When A collects 16,667u on the bond's maturity, A will have gain of 16,667u. At this time, A will owe taxes of 6,667u (40 percent multiplied by 16,667u).

The following table summarizes the three options:

	Tax-Exempt Bond	Taxable Bond	Deductible Taxable Bond
Gross Income	16,667u	16,667u	16,667u
Deductions	0	0	16,667
Taxes (40%)	6,667	6,667	0
Cash to Invest	10,000	10,000	16,667

Return at 10%	1,000	1,000	1,667
Taxes (40%)	Exempt	400	667
Net Return	1,000	600	1,000

By allowing A to deduct immediately the cost of the bond, the government, according to Cary Brown, "would literally be a partner in the firm."²² According to the Cary Brown model, it is as if the government had contributed 6,667*u* toward purchase of the bond. Since the government contributed this amount, which is 40 percent of the cost of the bond (6,667/16,667), it seems only fair that the government collect 40 percent of the interest on the bond. As a result, the government will collect 667*u* of each interest payment on the entire investment (667/1,667) and will recoup its "investment" when the bond matures (or is sold). At maturity, the investor will have gain of 16,667*u* resulting in taxes of 6,667*u* assuming that the tax rate remains at 40 percent. The government will therefore receive 6,667*u* in taxes from the investor, which is equal to the amount that the government originally "contributed."

By expensing the cost of the investment, the investor can increase the investment to $I/(1 - t)$, where I is the amount of income to be invested and t is the tax rate. In the above example, Investor would only have 10,000*u* to invest if the investment were not deductible. By being allowed to immediately deduct the cost of the investment, Investor would have 16,667*u* to invest (10,000*u*/(1 - .40)). Another way of looking at this is that Investor can increase the amount to be invested by the tax savings generated by expensing the cost of the investment.

22 See id.

D. Assumptions Underlying the Model

A number of assumptions or conditions must be made in order for the Cary Brown model to apply.²³ At first glance, these conditions appear to make the Cary Brown model very limited in scope. But this is very deceptive. The conditions are in some cases not unreasonable as a practical matter, and as a result, the Cary Brown model has a lot of practical application. In addition, even if some of the conditions are relaxed, much can still be learned by utilizing principles derived from the Cary Brown model.

The following list is taken from Professor Michael Graetz' excellent treatment of the subject in his textbook.²⁴ First, the applicable tax rates must remain constant. They can neither increase nor decrease over the time period in question. Second, interest rates must also remain constant. Like tax rates, they can neither increase nor decrease over time. Third, the deduction (or exclusion) must produce an immediate tax savings equal to the deduction (or exclusion) multiplied by the tax rate. This also means that the deduction must offset income from other sources and is not lost or delayed. In other words, the deduction results in an immediate tax benefit.

²³ See, e.g., Michael J. Graetz and Deborah H. Schenk, *Federal Income Taxation: Principles and Policies* 306-07 (1995); Michael J. Graetz, "Implementing a Progressive Consumption Tax," 92 *Harv. L. Rev.* 1575, 1602 (1979); Musgrave, *supra* note 13, at 262-67; Myron S. Scholes and Mark A. Wolfson, *Taxes and Business Strategy* (1992); Johnson, *supra* note 20 at 1031-1036; Shoup, *supra* note 13, at 266-69; Alvin C. Warren, "Accelerated Cost Recovery, Debt and Tax Arbitrage," 38 *Tax Law.* 549, 552 n.12.

²⁴ See Graetz and Schenk, *supra* note 23, at 306-07.

Fourth, taxpayers must be concerned with their after-tax position and can invest the tax savings from the deduction at a rate of return equal to the original investment. The opportunities for investment at the original rate of return are assumed to be unlimited. Fifth, "where borrowing is involved (again with constant tax and interest rates), the equivalence would hold only if the ratio of borrowing to after-tax investment were the same under a yield exemption and an immediate deduction. If speculative investment opportunities (or borrowing opportunities) were limited, after-tax differences between winning and losing taxpayers would be lessened under the immediate deduction method."²⁵ Sixth, "the system must be closed. Tax is collected at an identical rate on the earnings from an asset immediately deducted and on amounts received at the close of the transaction (whether by the disposition of the asset or by some other event, such as the taxpayer's death)."²⁶

IV. Samuelson Depreciation

The third important tax policy theory is closely linked to both the Haig-Simons definition of income and the Cary Brown model. In a famous paper published in 1964, MIT economics professor Paul Samuelson introduced the concept of economic depreciation, many times referred to as Samuelson depreciation.²⁷ The concept has been most clearly described in the tax law literature by Columbia Professor Marvin Chirelstein, and it is his example that will be used here.²⁸

Assume a taxpayer purchases equipment for 4,000 μ . In theory, the ideal amount of depreciation deduction each year is equal to the decline in value of the equipment each year. This

²⁵ See *id.* at 307.

²⁶ *Id.*

²⁷ See Paul A. Samuelson, "Tax Deductibility of Economic Depreciation to Insure Invariant Valuations," 72 *J. of Pol. Econ.* 604 (1964).

is consistent with the Haig-Simons definition of income in which income is defined as consumption plus (or minus) the change in the value of assets. Also, in theory, the taxpayer purchased the equipment for the income stream the equipment will generate for the taxpayer's business. Let's assume the equipment is expected to generate income of $1,200u$ each year for five years. The pre-tax rate of return for the taxpayer's investment in the equipment is slightly greater than 15 percent, compounded annually. In other words, $1,200u$ a year for five years discounted at a 15 percent rate of return, compounded annually, equals $4,000u$.

As a result, the present value of each payment is as follows:

Year	1	2	3	4	5	Total
Expected Receipt	$1,200u$	$1,200u$	$1,200u$	$1,200u$	$1,200u$	$6,000u$
Present Value	$1,045u$	$905u$	$790u$	$687u$	$573u$	$4,000u$

The total present value of all payments equals $4,000u$, which is the original cost of the equipment.

At the beginning of year one, the present value of the expected income stream is $4,000u$.

At the end of year one, there are only four $1,200u$ payments left to be received. When these four payments are discounted back to the end of year one at a 15 percent rate of return, compounded annually, the present value is $3,427u$. The loss in present value for year one is $573u$. As Professor Chirelstein has written:

28 See Marvin A. Chirelstein, *Federal Income Taxation* § 6.08 (Rev. 8th ed. 1999).

As each year of useful life expires the expected stream of payments become shorter and the present value of the sum of all remaining payments necessarily declines. There is just that much less to anticipate in the way of future returns. The taxpayer's economic loss from the year's operations - his annual cost - is measured by the decline in the present value of anticipated receipts which takes place between the beginning and the end of the taxable year. In effect, the difference between the value of the future income stream on January 1 and its value on January 1 of the following year represents the cost of using the machine for the year in question. If the object of the depreciation allowance is to reduce gross income by the true cost of operations, then the annual allowance should be no more or less than that amount.²⁹

The schedule of the annual decline in the present value of the income stream that represents the taxpayer's investment in the equipment is as follows:

	Present Value of the Investment	Present Value of Payment (1)	Present Value of Payment (2)	Present value of Payment (3)	Present Value of Payment (4)	Present Value of Payment (5)	Annual Loss in Present Value
Beginning of Year 1	4,000 <i>u</i>	1,045 <i>u</i>	905 <i>u</i>	790 <i>u</i>	687 <i>u</i>	573 <i>u</i>	0 <i>u</i>
End of Year 1	3,427 <i>u</i>		1,045 <i>u</i>	905 <i>u</i>	790 <i>u</i>	687 <i>u</i>	573 <i>u</i>
End of Year 2	2,740 <i>u</i>			1,045 <i>u</i>	905 <i>u</i>	790 <i>u</i>	687 <i>u</i>
End of Year 3	1,950 <i>u</i>				1,045 <i>u</i>	905 <i>u</i>	790 <i>u</i>
End of Year 4	1,045 <i>u</i>					1,045 <i>u</i>	905 <i>u</i>
End of	0 <i>u</i>						1,045 <i>u</i>

²⁹ See id. at § 6.08.

Year 5							
Total							4,000u

From the above chart, the taxpayer's depreciation deduction each year should be: 573u in year one; 687u in year two; 790u in year three; 905u in year four; and 1,045u in year five. As a result, the theoretically proper amount of depreciation decreases each year – the exact opposite of accelerated depreciation.

It is generally conceded that it would be very difficult to adopt Samuelson depreciation. The primary reason is the difficulty in predicting the income stream that the equipment is expected to generate. This is in contrast to assets such as mortgages, leases, and zero coupon bonds, in which the future payments are generally fixed by contract and therefore can be easily determined. As shown, Samuelson depreciation "is simply a function of expected cash flows."³⁰ Despite the difficulty in applying Samuelson depreciation, however, it "is the only proper method of apportioning the taxpayer's capital investment in accordance with the economic cost of use."³¹

It should be noted, however, that the United States has adopted principles based on Samuelson depreciation in areas even where the future payments are not fixed. For example, the rules for contingent payment debt instruments require adoption of a rate of return even though the actual payments may vary from the projected payment schedule using the rate of return. Any difference between the projected payments and the actual contingent payments is accounted for at a subsequent period in time when the actual contingent payments are made.

30 Id.

31 Id.

**Structuring of a Modern Capital Market:
The Swiss Example**

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Structuring of a Modern Capital Market: The Swiss Example

Outline of Presentation

1. Existing Legislation

1.1 Swiss Constitution

Switzerland as a federal state, composed of 26 cantons, knows a division of legislative authority between the federal government and the cantons; the federal government is authorised to enact laws only in the areas specifically mentioned in the Federal Constitution. In principle, capital market laws belong to the federal legislative authority; as long as this competence, however, had not been exercised, the cantons were free to regulate the stock exchanges active in their territory. Until 1996, several stock exchanges existed in different cantons; then, in the light of the globalisation of the capital markets the stock exchanges decided to combine their efforts in a joint association which now organises the Swiss Exchange in Zurich.

1.2 Stock Exchange Act 1995

The Swiss Federal Act on Stock Exchanges and Securities Trading (Stock Exchange Act) has come into force in 1995 after a 8 years history. The Stock Exchange Act is the legal basis for the enactment of several ordinances. The previous cantonal laws have lost their effect.

The Stock Exchange Act only regulates securities transactions on the secondary market; after some considerations, the legislator decided that the primary market activities should be left to the rules of the Swiss Federal Code of Obligations; nevertheless, it cannot be overlooked that the provisions of these laws are much less transaction oriented and do not provide for the same degree of transparency as the provisions of the Stock Exchange Act.

According to its Art. 1, the Stock Exchange Act the purpose of ensuring transparency and equal treatment for investors (individual protection of investors) as well as of providing the framework for the proper functioning of the securities market (functional protection of the market).

1.3 Investment Fund Act 1993

The Federal Investment Fund Act, enacted 1993, regulates the activities of Swiss investment funds (i.e. open-end funds whose management is domiciled in Switzerland) and of foreign investment funds distributing their certificates in Switzerland. The Investment Fund Act complies in many respects with the Investment Fund Directive 85/611 of the European Union.

Switzerland knows a quite restrictive notion of investment funds: The Investment Fund Act only covers the promotion of open-end funds being organised as unincorporated collective investment agreements making respective public advertisements. Therefore, in-house funds and collective schemes using a corporation as vehicle do not fall into the scope of the Investment Fund Act.

1.4 Banking Act 1934 and Insurance Supervision Act 1978

Banking activities are subject to the regulations by the Swiss Federal Act on Banks and Savings Institutions of 1934, as amended; the purpose of this law mainly consists in the protection of the depositors. The provisions mainly governing the organisation and the market activities of banks are quite detailed in the law and its ordinance.

The private insurance business in Switzerland is primarily regulated by the Federal Act on the Supervision of Private Insurance Companies of 1978, as amended. The purpose of this law is the protection of the insured persons. Since insurances have not been very active in the capital market until a few years ago, this law does not properly address capital market issues.

2. Institutions of the Capital Market

2.1 Stock Exchange

The Swiss Exchange, known in short as SWX, is owned and operated by the Swiss Stock Exchange Association, a legal entity (association) composed of all exchange members (banks, securities dealers). The SWX is a fully computerised, order-driven trading system for stocks (equity securities), bonds and derivative instruments; however, commodity exchanges are not subject to the Stock Exchange Act. The organisation of stock exchanges is governed by the principle of self-regulation as stated in Art. 4 of the Stock Exchange Act; the respective provisions (e.g. organisational rules, listing requirements) have been enacted by the SWX.

The operation of a stock exchange is subject to the authorisation given by the Federal Banking Commission. The respective license allows the supervisory authority to intervene if the stock exchange does not observe the legal prudential rules.

2.1.1 Organisation

The Swiss Exchange is organized as an association according to the Swiss Civil Code; it is structured as a business organisation with internal supervisory bodies.

2.1.2 Functions

- Admittance of Securities Dealers

The Swiss Exchange has issued regulations regarding the admission, duties and exclusion of securities dealers; according to Art. 7 of the Stock Exchange Act these regulations shall reflect the principle of equal treatment of the participants. The Swiss Exchange has established an internal supervisory and controlling body for complaints of securities dealers.

- Listing of Securities

The Swiss Exchange has issued regulations regarding the listing of securities, which contain provisions relating to the negotiability of securities, the information to be furnished by the companies to the investors and the internationally recognised accounting standards.

- Organisation of Trade of Securities

The Swiss Exchange has issued regulations which are designed to organise the market in order to achieve efficiency and transparency.

2.1.3 Supervision

An internal supervisory and controlling body, composed of experts in financial market matters, has been established in order to allow the market participants to file a complaint against actions and decisions rendered by the management of the Swiss Exchange. The final supervision is assumed by the Federal Banking Commission.

2.2 Banks

2.2.1 Universal Banking System

Switzerland knows a so-called universal banking system. By legal definition, the business of a bank consists in accepting deposits from the public and extending credits on its own account and its own risk to third persons/entities allowing the bank to earn its income from the difference (spread) between interest rates charged for credits and interest rates paid on deposits. However, banks are nowadays also very active in other areas of the financial sector, in particular in the investment banking. Nevertheless, contrary to the dual banking system in the USA, no division exists in Swiss law between the commercial banking and the investment banking business. Consequently, most securities dealers in Switzerland are banks.

2.2.2 Scope of Application of Banking Act

The Banking Act applies to all commercial enterprises engaged in the banking business; exempted from the scope of application are securities dealers, exclusively trading on the account of customers on the stock exchange, and asset managers. The provisions regulating the mostly state-owned cantonal banks have been recently adjusted to the general banking rules.

2.2.3 Licence System for Swiss and Foreign Banks

The banking business can only be executed after receipt of a respective banking license by the Federal Banking Commission. The license is granted if several conditions are met in particular:

- **Organisational Requirements**

Swiss banks must have a place of business in Switzerland, a fully paid-in capital of no less than CHF 10 Mio., a clearly defined scope of business in the articles of incorporation and in supplementary rules, an adequate internal organisation, appropriate risk management procedures and an effective internal control system (internal inspectorate).

- **Directors, Managers and Qualifying Shareholders**

The Banking Act explicitly requires that the directors and the managers of a Swiss bank must have a good reputation and offer assurance of a proper business conduct; the Federal Banking Commission makes quite extensive use of its discretion in interpreting the term „proper business conduct“.

Likewise, so-called qualifying shareholders of a bank, holding 10% or more of the capital or voting rights, are - similarly as in the European Union – also subject to the test of the “proper business conduct” by the Federal Banking Commission.

- Conduct of Business

If a financial institution carries out banking business without having received a proper licence, the responsible persons are liable to criminal prosecution.

- Particularities for Foreign Shareholders

A bank, domiciled in Switzerland, is considered to be foreign-controlled if one or more foreigners directly or indirectly hold qualifying shareholdings exceeding 50% of the voting rights or if foreigners otherwise exercise a controlling influence on the bank. The Banking Act makes it clear that a foreign bank incorporating a subsidiary in Switzerland needs to be aware of the fact that such subsidiary is subject to the Swiss banking supervisory rules. The license will be granted to a foreign controlled subsidiary if (1) the home country of the foreign bank grants reciprocal treatment to Swiss banks establishing banking operations in such country, (2) if the foreign-controlled bank is not choosing a corporate name suggesting that the bank is controlled by Swiss persons, (3) if the foreign-controlled bank is complying with the information rules of the Swiss National Bank, (4) if the rules of the Swiss Code of Obligations related to the corporate structure are observed and (5) if in case of a financial conglomerate an adequate supervision on a consolidated basis is given.

Special rules apply if a foreign bank envisages to establish a branch or a representative office in Switzerland: In particular, the Federal Banking Commission is looking at the supervision of such bank in its home country and the existence of reasonable internal rules defining the organisation and the scope of business of such entity in Switzerland.

2.2.4 Financial Soundness Rules

According to Art. 4 of the Banking Act, Swiss banks must provide for an adequate relationship between (i) their equity and their total liabilities and (ii) their liquid assets and easily marketable assets on the one hand and their short-term liabilities on the other hand. The respective principles lead to a number of regulatory consequences.

- Capital Adequacy Requirements

Swiss law basically follows the international standards set by the Basle Committee on Banking Regulations and Supervisory Practices, distinguishing between several elements of capital (upper tier and lower tier). The respective rules are set forth in the ordinance in a very detailed way.

- Large Exposures

The Banking Ordinance requires certain degrees of risk distribution by establishing maximum levels of credit; in particular, large credit exposures are limited.

- Consolidation

If a Swiss bank forms part of a group of companies, the requirements on capital resources and the spreading of risks have also to be satisfied on a consolidated basis; this principle requires the cooperation between several supervisory authorities on an international level.

- Liquidity Requirements

Detailed rules govern the liquidity of a bank; in particular, liquid assets and easily marketable assets, measured against short-term liabilities, should constitute a safety cushion (fractional reserve banking guidelines).

- Accounting and Audit

The financial statements of a bank do not only have to be prepared in accordance with the provision of Swiss corporation law, but also of the Banking Ordinance which additionally contains detailed rules on the form and structure of the financial statements. The publication on a statutory and eventually on a consolidated basis has to be done yearly within 4 months after the close of the business year, in case of banks with assets exceeding CHF 100 Mio. semiannually.

The financial statements of a bank are subject to a specific review by qualified auditors; as a speciality, Switzerland provides for an auditing system in which the auditors are requested to assist the Federal Banking Commission in its supervisory functions. Therefore, the report of the auditors has to be more detailed than in case of other corporations (so-called long-form report). Nevertheless, it cannot be overlooked that this system might lead to potential conflicts of interest if the auditors are aware of certain undisclosed facts and are at risk to lose the mandate of the company if the information is passed on to the supervisory authority.

2.2.5 Supervision

The supervision of the Swiss banking industry is executed by the Federal Banking Commission having quite large competences by law.

- Cross-Boarder Supervision

In case of a Swiss bank belonging to an international conglomerate, the Federal Banking Commission may cooperate

with foreign banking or securities supervisory authorities. The Banking Act expressly provides for disclosure of information rules.

- Consolidated Supervision

The Banking Act allows foreign-controlled banks to make data available to their foreign parent companies without violating Swiss banking secrecy rules, as far as such disclosure is strictly necessary for the purposes of consolidated supervision.

2.3 Securities Dealers

Three types of securities dealers exist under the Stock Exchange Act, namely Broker-Dealers, Underwriters and Derivatives Houses.

2.3.1 Definition

- Broker-Dealers

Broker-Dealers are persons or entities buying and selling securities on a professional basis on the secondary market. In particular, the statutory definition of the Stock Exchange Act includes the following market participants: (1) Dealers trade in securities on their own account on a short term basis. (2) Market makers continuously or upon request provide quotes for securities to the public. (3) Brokers buy and sell securities in their own name, but for the account of third parties. Certain market participants, namely individual investors, asset managers and certain institutional investors are not considered to be securities dealers.

- Underwriters

Underwriters are persons or legal entities making primary offerings of securities to the public on a professional basis.

- Derivatives Houses

Persons that are mainly active in the financial sector creating and offering thereby derivatives to the public on a professional basis, whether on their own account or for the account of a customer, are

also considered securities dealers in their functions as derivatives houses.

2.3.2 Licence System for Swiss and Foreign Securities Dealers

The legal system in respect of the securities dealers has by purpose been regulated in a similar way as in the case of banks, among others due to the fact that most securities dealers are Swiss banks and in order to achieve equal treatment of the market participants.

- Licence System for Swiss and Foreign Securities Dealers

Securities dealers need a licence from the Federal Banking Commission for taking up a business in Switzerland. In case of foreign securities dealers the conditions such as the reciprocity and the compliance with general Swiss law are quite similar as in case of banks.

- Organisational Requirements

Securities dealers have to ensure by internal rules and by an adequate organisation that they can comply with the duties provided by law. In particular, persons or entities have to be mainly active in the financial sector and the scope of business needs to be defined in detail. The minimum capital of a securities dealer amounts to CHF 1,5 Mio. Further conditions concern the risk management procedures and the establishment of an internal inspectorate.

- Directors, Managers and Qualifying Shareholders

Directors and managers have to demonstrate the necessary professional knowledge and must offer every assurance of proper business conduct as in the case of banks. Significant shareholders controlling at least 10% of the voting rights or the capital of the securities dealer are on the same scrutiny.

- Conduct of Business

Persons starting a business prior to the granting of a licence are subject to criminal prosecution.

- Particularities for Foreign Securities Dealers

Foreign securities dealers must be adequately organised in their home country; furthermore, Switzerland needs to receive the assurance that reasonable supervisory measures are taken in the home country.

2.3.3 Prudential Rules

- Rules of Conduct

Art. 11 of the Stock Exchange Act provides for specific rules of conduct, namely a duty of information, a duty of diligence and a duty of loyalty towards the customers (cf. No. 3.3 below).

- Financial Soundness

Securities dealers need to have sufficient capital resources (own funds) available to cover their exposures. In case of a group structure the same principle applies on a consolidated basis. The details are regulated in the ordinance to the Stock Exchange Act.

- Accounting and Audit

In respect of the accounting the securities dealers have to observe the regulations contained in the Banking Ordinance by analogy; annual financial statements have to be published.

The activities of the securities dealers are subject to a special audit by approved auditors. The details of the audit are regulated in the ordinance to the Stock Exchange Act.

- Record-Keeping and Reporting

The Stock Exchange Act and its ordinance contain several record-keeping and reporting obligations of securities dealers which should help to establish transparency in the capital market.

2.4 Insurance Companies

2.4.1 Regulated Activities

The regulatory regime in the insurance field is not homogeneous in Switzerland. Some areas of insurance services are dominated by private companies being under a general governmental supervision, other areas know mainly state-controlled insurers. The supervision of the insurers mainly concerns direct insurance companies and reinsurance companies.

2.4.2 Licence System for Insurance Companies

All insurance companies being subject to Swiss private insurance regulation need to have a business licence prior to the taking up of the business in Switzerland. The organisational and human conditions to be met by the insurance companies are in general more flexible than in the banking sector.

2.4.3 Investment and Solvency Requirements

The applicable laws know many investment guidelines, particularly for the so-called safety funds. Furthermore, Swiss law requires a solvency margin to be maintained between an insurer's own funds and its potential future exposure.

2.5 Investment Funds

2.5.1 Notion of Swiss Investment Funds

The Swiss Investment Fund Act covers only the so-called open-end funds being organised as unincorporated invested agreements and making public advertisements to attract investors.

2.5.2 Organisational Requirements

- Fund Management

The fund management of a Swiss investment fund has to be a Swiss Company having its principal place of business in

Switzerland. The fund management may not engage in any business other than managing investment funds. The fund management decides on the investment strategy.

- Depository

The depository of a Swiss investment fund must be a bank incorporated in Switzerland. The depository is responsible for the safekeeping of the assets held by the investment fund. Fund management and depository have to be separate legal entities by law.

- Sales Force

Any independent sales agents must apply for an authorisation to distribute investment fund certificates. The licence is granted if the persons have the necessary professional qualifications.

2.5.3 Investments

- Securities Funds

Securities funds have to predominantly invest in shares, debts, instruments and derivative instruments listed on a stock exchange or regulated market, similar to the EU-directive of 1985. In particular, investments fund may not engage in transactions which are to be considered as speculative (such as short selling or excessive leveraging).

- Real Estate Funds

Real estate funds may invest in real property, shares of and claims against real estate companies, and mortgages and similar instruments.

- Other Funds

Other funds may invest in securities, precious metals, foreign currencies, standardised derivative products, currency futures and currency swaps. Due to the increased risks of derivative

instruments, the customer has to be informed about changes and problems of a potential investment.

2.5.4 Disclosure Requirements

- Fund Regulations

An investment fund may only be offered to the Swiss public after the Federal Banking Commission has approved the fund regulations established by the fund management and the depository bank.

- Prospectus

The publication of a prospectus is mandatory prior to the opening of the placement of the investment fund certificates. The respective information relates to the fund management, the depository bank and important agreements.

- Continuous Reporting

The continuous reporting by the fund management shall lead to a better transparency.

2.5.5 Foreign Investment Funds

The distribution of certificates of foreign investment funds to retail investors in Switzerland on a professional basis is subject to authorisation by the Federal Banking Commission. Switzerland accepts much more different forms of investment vehicles as provided in the law of Swiss investment funds; particularly closed-end funds are possible in Switzerland. Furthermore, since November 1997 a special exemption exists for the sale of certificates in foreign investment funds to institutional investors. If a foreign investment fund shall be marketed in Switzerland, the promotor of the fund must appoint a Swiss representative being required to apply for a distribution licence to be issued by the Federal Banking Commission. The licence will be granted (1) if the foreign investment fund is subject to official supervision in its home country comparable with the Swiss supervision on investor

protection, (2) if the organisation and investment policy of the foreign investment fund are equivalent as under Swiss law, (3) if the name of the foreign investment fund is not misleading and (4) if the Swiss representative has established a place of payment at a Swiss bank.

3. Transactional Rules in the Capital Market

3.1 Issuing Securities

3.1.1 Issuing Equity Securities

- Types of Equity Securities

A Swiss corporation may issue three types of equity securities, namely shares, participation certificates and bonus certificates. The usual form are shares of common stock, the other types have lost practical importance in the last few years.

- Disclosure Requirements

If the newly issued shares are the object of a public offering, it is mandatory for the issuer to observe certain information requirements which are contained in the Swiss Federal Code of Obligations (Art. 652a). The main information concerns legal data related to the issuing corporation; the extent of the information is not very broad. If the issued shares should be listed at the Swiss Exchange, the special listing rules of the SWX must be observed (cf. No. 3.2 below).

- Secondary Distributions

In case of secondary distributions the shares are usually underwritten and marketed by a syndicate of banks or securities dealers and only afterwards listed on the SWX. Secondary distributions are not subject to special disclosure requirements.

- Particularities for Foreign Issuers

A foreign issuer of securities has to comply with the public offering rules on the Swiss market (e.g. issuance of a prospectus); furthermore, a foreign company has to observe the securities laws at the place of its incorporation.

3.1.2 Issuing Debt Securities

- Types of Debt Securities

Publicly offered securities are bonds. Debt securities sold through a private placement in Switzerland are called notes.

- Disclosure Requirements

Similar disclosure requirements are applicable in case of issuance of bonds as in case of shares of common stock; the respective rule of the Swiss Code of Obligations (Art. 1156) corresponds to the rule in the corporation law. The necessary information is to be given in the terms of the bonds which have to be public; further details can be agreed in the bond issue agreement.

- Particularities for Foreign Issuers

Foreign issuers of debt securities do not only have to comply with the rules governing the activities of Swiss issuers but also eventual additional regulations in respect of capital export; for the time being, only information duties are to be observed.

3.1.3 Derivative Instruments

Derivative Instruments may be issued by the corporation which has issued the underlying securities. A third-party derivatives issuer needs to be licensed as securities dealer. The disclosure requirements of the Swiss Code of Obligations are rather remote; however, more transparent duties are known in the listing rules of SWX.

3.1.4 Liability Provisions

- Equity Securities

A liability of the issuer can be based on the fact of false or misleading statements in connection with the issuance of equity securities. The Swiss court practice has so far been relatively hesitant in assuming a violation of rules by the concerned corporation; decisions which have forced an issuer to pay damages for misleading information are much more frequent in other countries of the European Union.

- Debt Securities

In principle, the same rules apply in case of misleading information in connection with the issuance of debt securities as in the case of equity securities.

- Derivative Instruments

The same rule as in case of the issuance of equity securities applies in case of derivative instruments.

3.2 Listing Rules of the Stock Exchange

The Listing Rules of the Stock Exchange are not released by a governmental body, but by the Swiss Exchange (SWX) based upon Art. 8 of the Stock Exchange Act. The SWX is requested to take into account internationally recognised listing standards; the Listing Rules of the SWX, being in force since October 1, 1996, comply with this requirement apart from a few exceptions.

3.2.1 Listing Procedures

The Swiss Admission Board of the SWX decides on the listing of securities. An issuer has to file a special application with the Admission Board; if the listing is denied the right of the appeal is given at first instance to an internal court of appeals of the SWX and afterwards to the civil courts.

3.2.2 Substantive Requirements for Listing

- Requirements for Issuer

Certain requirements concern the issuer, namely the existence of the corporation (at least three years prior to the listing application) and the capital resources (net equity of at least CHF 25 Mio.). If the issuer is a special purpose vehicle, the requirements may be met by a group company giving a special guarantee or surety.

- **Applicable Law**

Equity securities have to comply with the law at the issuer's place of incorporation. Debt securities issues on the Swiss capital market and listed on the SWX must usually be made subject to Swiss law, however, certain exceptions do exist (medium term note programs, public law institutions).

- **Minimum Capitalisation**

The Minimum Capitalisation amounts to CHF 25 Mio. for equity securities, to CHF 20 Mio. for debt securities and to CHF 10 Mio. for derivative instruments (except in case of options of shareholders: CHF 2 Mio.).

- **Distribution of Securities prior to Listing**

In principle, the issuer of equity securities and the lead manager of an issue of debt securities or derivatives instruments have to ensure that an adequate distribution of securities among the public on or before the first listing day is given.

3.2.3 Listing Particulars (Prospectus)

- **Contents**

The Listing Rules of the SWX contain detailed rules in respect of the contents of the prospects to be published in connection with the issue. In particular, information has to be given on the issuer and the guarantor, if applicable, on the securities and on the persons and entities responsible for the listing particulars.

- **Financial Information**

The financial information given by the issuer has to be in line with the provisions of the applicable law and with the accounting rules established by the SWX. If the financial statements are older than nine months at the time of the listing, interim financial statements have to be issued.

- Accounting Standards

Art. 67 of the Listing Rules explicitly requires that the accounting rules promulgated by the SWX must be observed. These Accounting and Reporting Recommendations constitute a special Annex II to the Listing Rules. The International Accounting Standards (IAS) and the US Generally Accepted Accounting Principles (US GAAP) are in line with the specific requirements of the SWX, not, however, the rules of Swiss corporation law.

- Addressee of Listing Particulars

The listing particulars have to provide enough information for knowledgeable investors to reach an informed assessment of the assets and liabilities, the financial position, the profits and losses as well as the prospect of the issuer. Therefore, the level of information has not to be designed in a way, that a completely inexperienced investor can take advantage of such information.

3.2.4 Ongoing Disclosure Obligations After Listing

- Disclosure of Financial Information

An issuer is requested to publish its business report on an annual basis. The details of the business report need to have the quality of the information requested at the time of the listing of the securities.

- Disclosure of Material Information (Ad hoc-Publicity)

A very important provision of the Listing Rules is its Art. 72 dealing with the so-called Ad hoc-Publicity. The background of this provision has to be seen in general principle of transparency; any price-sensitive facts (such as merger, take-over, substantial

losses) should become public as soon as possible in order to avoid that potential insiders could take advantage from early information. The SWX has issued a special brochure interpreting and describing the contents of Art. 72 of the Listing Rules; nevertheless, some points have not yet been clearly established and no decision on a damage claim has been rendered against an issuer which has not complied with the Ad hoc-Publicity.

- Disclosure of Changes in Terms of Listed Securities

An issuer is obliged to disclose all relevant changes in the rights attached to listed securities and under the terms of a bond issue.

3.2.5 Suspension and Cancellation of Listing (Delisting)

The Admission Board may, at the request of the issuer or on its own initiative, temporarily suspend the trading of securities on the SWX if unusual circumstances make such move advisable. The Admission Board may also cancel the listing of a security if specific events occur (e.g. insolvency of issuer, no transactions for a long time, breach of the Listing Rules by the issuer).

3.3 General Rules of Conduct

In very clear words Art. 11 of the Stock Exchange Act provides for general rules of conduct which usually would have the relevant background in civil law, particularly in mandate law. Such double rule leads to the question whether the violation of a public law principle necessarily is to be considered as breach of the civil law duties and vice versa. So far clear court practice is not available. Nevertheless, a guideline issued by the Swiss Bankers' Association in February 1997 gives further details on these rules of conduct and can be considered as "standard practice".

3.3.1 Duty of Information

A securities dealer has to draw the attention of a customer to the risks involved in the category of transactions which the customer is choosing in the framework of his investment policy. Consequently, the

information has to cover aspects which are in general important for a special category of transactions, not individual risks.

3.3.2 Duty of Diligence

A securities dealer has to comply with the principle that its customers receive the best possible execution of their orders; this principle implies the applicability of the so-called „best execution rule“. Furthermore, the investor must be in a position to trace back the settlement of his orders.

3.3.3 Duty of Loyalty

A securities dealer must ensure that its customers are not disadvantaged by any potential conflict of interest. This guideline which would anyhow be applicable under civil law view points draws the attention of the securities dealers to the fact that conflicts of interests could primarily occur in case of parallel tradings.

3.4 Disclosure of Substantial Shareholdings

For the first time in Swiss capital market law, the Stock Exchange Act provides in its Art. 20 for the obligation of disclosure of substantial shareholdings; due to the fact that the ordinance giving further details to the general obligations has been highly debated in Switzerland, this part of the Stock Exchange Act has only come into force on January 1, 1998. The disclosure obligation applies to Swiss companies having at least one class of equity securities listed on a stock exchange in Switzerland.

3.4.1 Transactions Subject to Disclosure (Stock Exchange Act)

- Acquisition and Disposal of Shares

Shareholders have to report the acquisition or disposal of shares on their own account and on the account of a third person meaning direct and indirect share transactions have to be reported. The disclosure obligation also concerns the beneficial owner having mandated a third person to acquire shares in a fiduciary capacity. The term „acquisition and disposal of shares“ includes all types of share transfers including share exchanges,

donations, inheritances, conversions of shares and usufructuary rights.

- Transfer of Voting Rights

All share transactions which have the effect of conferring voting rights relating to equity securities on a person are subject to the disclosure obligation. This principle primarily applies in connection with securities lending and repurchase agreements.

- Derivatives Transactions

After long discussions, the legislator has decided that the acquisition and disposal of call options and conversion rights, provided the terms of the options give the right of physical delivery of the underlying shares, and the writing of put options, provided the terms of the options give the right of physical delivery of the underlying shares, are subject to the disclosure obligation. Furthermore, a de-minimis-exception exists: If the underlying shares covered by derivatives transactions do not amount to 5% of the corporation's voting rights, such transaction does not need to be reported.

- Group Privilege

Organised groups of shareholders and shareholders acting in concert have the privilege of complying with the disclosure obligation as a whole. This privilege applies to groups of companies and companies under common control, to shareholders who establish or terminate agreements relating to the exercise of voting rights and/or relationships in order to acquire or dispose of shares. The question is still discussed whether a loose understanding between shareholders already qualifies as relevant agreement. The advantage of the group reporting is to be seen in the fact that changes within the group do not need to be reported.

- Special Disclosure Events

Special disclosure events are given if a company increases, restructures or reduces its capital, if a company buys or sells its own shares, if in-house funds buy or sell shares or if investment funds buy or sell shares; in the latter case the fund management has to do the reporting.

3.4.2 Relevant Thresholds

Disclosure has to be made if a shareholder or group of shareholders acquires or disposes of shares and thereby reaches, exceeds or falls below the limits of 5%, 10%, 20%, 33 1/3%, 50% or 66 2/3% of the voting rights of the concerned company. These thresholds correspond to a large extent to specific minority rights in the Swiss corporation law.

3.4.3 Disclosure Procedures

A shareholder being subject to disclosure has to report the relevant transaction, both to the concerned company and to the stock exchange on which the shares are listed. The details which have to be mentioned in the specific report are listed in the ordinance to the Stock Exchange Act; special formats are available with the SWX.

The company must also publish the information it has received from its shareholders within another two exchange trading days of receipt.

3.4.4 Supervisory Rules

The Swiss Exchange has issued compliance procedures which are to be observed by the concerned shareholders. In special cases, the Swiss Exchange may exempt a shareholder from the reporting requirements. Important reasons for such exemption are given if the relevant threshold is only passed for a short time, if the acquirer has no intention to exercise the voting rights and if the share transfer is subject to a condition precedent.

If a concerned shareholder is in doubt whether or not a certain transaction falls under the obligation of disclosure, the possibility exists to obtain from the Swiss Exchange a preliminary ruling which will be given according to a special ordinance.

3.4.5 Further Disclosure Rules

Further Disclosure Rules exist in the corporation law, in the Investment Fund Act and in the Banking Act; in particular, corporations the shares of which are listed on a stock exchange shall disclose in the notes to the balance sheets significant shareholders and their participations, provided they know or ought to know of such shareholders which can be difficult in case of bearer shares. The disadvantage of such rule is to be seen in the fact that the report is issued only once a year and hence not giving enough transparency for the capital market.

3.5 Tender Offers

3.5.1 Scope of Application of Stock Exchange Act

- Covered Transactions
 - Tender offers are cash purchase or exchange offers addressed publicly to the holders of equity securities of Swiss companies (target companies) having at least one class of equity securities listed on a Swiss stock exchange.
 - Self-tenders (public offers by a company to purchase its own shares) fall into the scope of application of the Stock Exchange Act; certain self-tenders, however, are exempted, such as transactions of 2% or less of the share capital of the company subject to equal treatment of all shareholders.
 - The Stock Exchange Act does not exempt restructurings from the scope of application, however, the Takeover Board may exempt a restructuring scheme subject to the given individual circumstances.
- Not covered transactions
 - Non-public share purchases
 - Take-overs of foreign and unlisted companies
 - Purchase offers for bonds

3.5.2 Organisation and Functions of Takeover Board

The Stock Exchange Act provides for the establishment of a special Takeover Board, appointed by the Federal Banking Commission and adequately representing the various interest groups in the capital market. Consequently, the membership in the Takeover Board is not a full-time job.

The Takeover Board has to review the tender offers, to give recommendations to the interested parties, particularly stating the compliance with the applicable regulations, to issue binding decrees to inform the interest parties and to give advance rulings if requested. The procedural rules are contained in an ordinance to the Stock Exchange Act and in special regulations of the Takeover Board.

3.5.3 Duties of Offeror

- Equal Treatment

An offeror is obliged to extend equal treatment to all holders of securities of the same class. However, an offeror does not necessarily have to make an offer for all classes of securities or for the options or conversion rights of securities. If the tender offer is made for several classes of equity securities, however, the equal treatment principle generally applies, i.e. the tender offer must be extended to all classes of listed equity securities of the target company. Nevertheless, the equal treatment rules applies only to the tender offer; therefore, the offeror may, prior to the launch of the tender offer, buy equity securities at a premium (i.e. at a higher price).

- Conditional Offers

The offeror may make an offer conditional, however, only conditions precedent may be imposed to the closing that cannot be influenced to a significant extent by the offeror. The usual conditions concern the entry of the offeror as shareholder in the share register and the availability of regulatory approvals.

- Revised Offers

A revised offer has to improve the overall position of the shareholders of the target company.

- Concert Parties

The obligations of the offeror also apply to all concert parties of the offeror; persons acting in concert with the offeror must be identified in the offer prospectus.

3.5.4 Tender Offer Procedures

- Announcement

In the preliminary announcement the offeror has to disclose the substance of the subsequent tender offer, including particulars of the offeror and of the target company, the equity securities at stake and the offer price, the tentative timetable of the tender offer and the conditions, if any. The preliminary announcement must be published in at least two Swiss newspapers.

- Offer Prospectus

A tender offer has to be made public in a prospectus which need to be correct and complete containing all relevant information which are suitable and necessary for an appropriate evaluation of the tender offer. The exact contents of the tender offer are described in the ordinance to the Stock Exchange Act; particularly, information has to be given on the offeror, on the object of the tender offer, on the target company, on the publication, on the examination by the review body and the filing with the Takeover Board.

- Offer Period and Acceptance of Offer

Usually, after the publication of a tender offer, a “cooling period” during ten exchange trading days is running, allowing the board of directors of the target company to prepare a report to its

shareholders and the Takeover Board to examine and issue a recommendation on the offer. The tender offer has to remain open during an offer period of no less than twenty and no more than forty exchange trading days. At the end of the initial offer period, the offeror determines and the review body confirms the preliminary result of the offer. If the conditions of the offer, if any, have been met, the offeror must extend the offer period for another ten exchange trading days. A tender offer may be prohibited, by court order or administrative decree, if the terms of the offer or the conduct of any party involved in the offer, including the target company, violates applicable laws. In such case the selling shareholders have the right to withdraw their acceptances of the tender offer.

- Share Transactions During Tender Offer

In order to achieve full transparency certain shareholders have to report all acquisitions and sales of equity securities in the target company, namely the offeror, concert parties of the offeror and substantial shareholders of the target company. The offeror must publish all transactions in equity securities of the target company on a daily basis. Moreover, after announcement of the tender offer, the offeror and its concert parties are restricted from buying equity securities of the target company at a premium.

3.5.5 Duties of Target Company

- Report to Shareholders

The board of directors of the target company is obliged to issue a report on the tender offer containing all information necessary to allow shareholders to make an informed decision. This report should also contain information about the intentions of substantial shareholders of the target company and about potential conflicts of interest of the directors. This topic is very sensitive in practice; if the board of directors is emphasizing negative aspects, it is likely that in case of a successful tender offer the members of the board will be immediately replaced; if the board of directors is

overestimating the positive aspects, the shareholders might be misled.

- Restrictions and Defensive Tactics

The board of directors of the target company is restricted in its ability to introduce defensive measures against a tender offer; in particular, the company may not engage in any transactions that would alter to a significant extent the assets or liabilities of the company, such as the conditional sale of “crown jewels”, the conclusion of “golden parachut” or “poison pill”-agreements, the issue of new shares or convertible debts. After the tender offer has been launched, only the shareholders meeting of the target company may decide on any relevant defensive measures.

- Reaction to Competing Offers

Basically the target company has to treat all competing offers equally (cf. No. 3.5.6).

- Reporting of Share Transactions

The principal shareholders of the target company must report all transactions in equity securities of the target company on a daily basis.

3.5.6 Competing Offers

In case of competing offers it is imperative that the holders of the equity securities of the target company are able to choose freely among them. Therefore, any competing offer must be published no later than three exchange trading days before the end of the initial offer period. Once a competing offer is made, the initial offeror may revoke the initial tender offer until five days before the lapse of the offer period for the competing offer. The initial tender offer may also be revised. If several competing offers are made, the target company is obliged to grant equal treatment to all bidders.

3.5.7 Mandatory Offer Obligation

The mostly debated provision of the Stock Exchange Act has concerned the so-called mandatory offer obligation. Shareholders having a large stake in a company do often not like to be forced to make an offer to the remaining shareholders for financial reasons.

- **Opting Out**

A Swiss company may declare the mandatory offer obligation inapplicable (opting out). An opting out may be resolved before or after the equity securities of the company are listed on a Swiss exchange. Before the listing, a resolution in the shareholders' meeting has to be passed by absolute majority. After listing of the equity securities, such resolution may not be disadvantageous to the shareholders; court practice does not yet exist to this broadly worded condition.

- **Triggering of and Exemptions from Mandatory Offer Obligation**

The mandatory offer obligation is triggered whenever a shareholder or a group of shareholders directly or indirectly acquires equity securities exceeding the threshold of 33,3% of the voting rights of the target company. This relevant threshold may be raised by a resolution of the shareholders to an amount of 49% (opting up). The mandatory offer obligation applies once a share transaction that brings the offeror to the relevant threshold has been consummated.

The Stock Exchange Act and its ordinance contain a number of exemptions from the mandatory offer obligation such as acquisition of voting rights as result of a donation, of a foreclosure sale or of a corporate reorganisation. Moreover, the Takeover Board or the Federal Banking Commission, respectively, may grant a discretionary exemption or whitewash from the mandatory offer obligation if this appears to be justified under the given circumstances. The Takeover Board has mentioned possible whitewash situations in a special circular letter.

- **Minimum Price**

The offeror is obliged to buy all outstanding equity securities of the target company at no less than the stock exchange price. This price is designed as the average opening price on a Swiss exchange for the thirty exchange trading days before the publication of the offer document. Additionally, if the offeror has purchased equity securities at a premium prior to the tender offer, the minimum price offered for the tender equity securities must be the higher of the stock exchange price or 75% of the highest price paid by the offeror for equity securities of the target company in the 12 months preceding the announcement of the offer.

The price for the tendered equity securities may vary if the target company has issued several classes of equity securities. Under certain circumstances, exceptions from the minimum price rule apply.

- Procedural Rules

The mandatory offer has to be published within two months after crossing the relevant threshold except if the Takeover Board is extending this period for cause. Basically, the same procedural rules apply as in case of a voluntary tender offer.

- Buy-out right (squeeze-out)

An offeror may request a squeeze-out of the remaining shareholders if, after the tender offer, it holds more than 98% of the voting rights of the target company, including shares already held prior to the tender offer. The cancellation of equity securities is effected by court order.

3.6 Supervision

3.6.1 Competent Authorities

The supervisory authorities are the Federal Banking Commission and the Takeover Board.

3.6.2 Rights and Duties of the Supervisory Authorities

The Federal Banking Commission has the aim to induce the market participants to comply with the rules of the Stock Exchange Act and its implementing ordinances. The supervisory rules may be enforced by informal recommendations or formal decrees. If a market participant does not comply with a formal decree, the Federal Banking Commission has the right to revoke the business licence. The legal remedy against a formal decree of the Federal Banking Commission is the appeal to the Swiss Federal Supreme Court.

3.6.3 Cross-Boarder Supervision

In the light of the globalisation of the capital markets, the Federal Banking Commission may receive information from foreign supervisory authorities and may also deliver information to foreign supervisory authorities under certain conditions, particularly the principle of confidential treatment and the principle of reciprocity.

3.7 Criminal Provisions

3.7.1 Rules of Money Laundering

- Money Laundering and Lack of Care in Finance Matters

Since August 1990, the Swiss Federal Criminal Code makes money laundering a criminal offence: One who performs an act that may serve to prevent determining the origin of, tracing or confiscating funds that, as the offender knows, or should assume, stem from a criminal origin, is punished by imprisonment or fine. Money laundering is punishable in Switzerland regardless of whether the original crime was committed in Switzerland or abroad. A more severe punishment is possible in special cases; furthermore, chain laundering can also be a criminal offence.

The provision on money laundering is supplemented by an additional rule of good behaviour, specifically targeted at the financial sector: One who accepts, deposits, invests or assists in the transfer of funds from third parties on a professional basis, and fails to ascertain the identity of the beneficial owner with the due

care required under the circumstances, is punished by up to one year of imprisonment or by a fine. The background of this provision has to be seen in the objective to induce financial institutions to adhere to a high degree of care in finance matters.

- Special Rules of Conduct

As in the respective directive of the European Union, financial institutions have not only a right, but since 1998 a duty to notify the competent authorities if it is known or if there are good reasons to suspect that the assets involved in a transaction are connected to an act of money laundering, stem from a crime, or belong to a criminal organization. Additional rules of conduct are contained in the Banking Act.

- Supplemental Self-Regulation for Banks

Since 1977 the members of the Swiss Bankers Association are bound by a self-regulation covering the principle of due diligence in banking relations. In particular, banks are obliged to verify the identity of customers. The respective obligations apply now also to persons being active in the field of asset management.

3.7.2 Insider Trading

- Punishable Persons (Insiders, Tippees)

Since July 1988 insider trading is a criminal offence in Switzerland. The Swiss Federal Criminal Code punishes the abuse of confidential information by the actual insider (person possessing confidential information by virtue of professional or official function) and by a tippee.

- Elements of Offense

The elements of the offense of insider trading are the issuance of new equity securities, the combinations of businesses and similar events of comparable significance.

3.7.3 Breach of Professional Secrecy

The Swiss Federal Criminal Code contains a provision punishing specific secrecy holders for the illegal disclosure of confidential information. In a special provision the same principle is outlined in respect of state officers.

3.7.4 Breach of Banking Secrecy

- Scope in Principle

The banking secrecy provision applies to every person who can be in a position to obtain confidential information relating to the customers of the banks.

- Exceptions

The banking secrecy provision is subject to limitations; it may be waived by the customer or set aside under certain circumstances, namely the disclosure of information to the parent company for consolidation purpose or the disclosure under administrative law, in Swiss litigation and (partially) in foreign litigation.

3.7.5 Price Manipulation

The Stock Exchange Act has introduced a specific criminal rule on price manipulation; this rule serves to criminalize fraudulent practices on the financial market undertaken with the intention of influencing the price of securities listed in Switzerland dealt on a Swiss exchange in order to obtain an illegitimate profit. The crime may be committed by securities dealers or by their customers through knowingly disseminating information or forecasts relating to listed securities that are false or misleading or through carrying out transactions in securities directly or indirectly on the own account or for the account of person linked together for that purpose.

3.7.6. Technical Violations

- Conduct of Business without Authorization

- Breach of Reporting Obligations
- Breach of Obligations of Target Company

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Federal Act on Stock Exchanges and Securities Trading (Stock Exchange Act, SESTA)

of March 24, 1995

(Translation by Nadine Faruque)

The Federal Assembly of the Swiss Confederation,

based upon Articles 31^{bis}, 31^{quater}, 64 and 64^{bis} of the Federal Constitution, after having examined the Message of the Federal Council dated February 24, 1993 ¹⁾,

decides:

Chapter 1: General Provisions

Art. 1 Objective

This Act sets the conditions for the establishment and operation of stock exchanges as well as for the professional trading in securities, in order to ensure transparency and equality of treatment of investors. It provides the framework to ensure the proper functioning of the securities markets.

Art. 2 Definitions

For the purposes of this Act,

- a. "securities" shall mean standardised certificates which are suitable for mass trading, rights not represented by a certificate with similar functions (book-entry securities) and derivative instruments.
- b. a "stock exchange" shall mean any organization which is set up for the purpose of securities trading and which enables the simultaneous exchange of offers of securities among a number of securities dealers as well as the execution of transactions.
- c. "listing" shall mean admission to trading on the principal or second exchange.
- d. a "securities dealer" shall mean any natural person, legal entity or partnership who buys and sells securities, in a professional capacity, on the secondary market, either for its own account with the intent of reselling them within a short period of time or for the account of third parties, or makes public offers of securities to the public on the primary market, or creates derivatives and offers them to the public.

1) FG 1993 I 1369

- e. a "public takeover offer" shall mean any offer to purchase or exchange shares, participation or bonus certificates or any other participation rights ("equity securities") which is made publicly to the holders of shares or other equity securities of Swiss companies whose equity securities are, in whole or in part, listed on an exchange in Switzerland.

Chapter 2: Stock Exchanges

Art. 3 Authorization

1 The operation of a stock exchange is subject to authorization by the supervisory authority.

2 Authorization shall be granted if:

- a. the stock exchange through regulations and its organizational structure ensures compliance with the provisions of this Act;
- b. the stock exchange and its senior officials are able to show that they have the necessary professional knowledge and give an assurance of proper business conduct;
- c. the governing bodies meet such minimum requirements as the Federal Council may set out.

3 The Federal Council shall set out the requirements to be met by foreign stock exchanges which intend to operate in Switzerland but have no registered office here.

4 The Federal Council may subject organizations which are similar to exchanges, in whole or in part, to this Act or exempt certain exchanges or similar organizations from the application of this Act whensoever justified by the objectives of the Act.

5 In the event that the requirements for authorization are altered subsequently, the stock exchange must seek the approval of the Supervisory Authority for the continuation of its operations.

Art. 4 Self-regulation

1 The stock exchange must undertake to ensure that it has an organizational structure in respect of its operations, administration and supervision that is appropriate to its activities.

2 A stock exchange must submit its regulations and any amendments thereof to the Supervisory Authority for approval.

Art. 5 Market Organization

1 The stock exchange shall issue regulations which shall organize the market so as to achieve efficiency and transparency.

² The stock exchange shall maintain a daily chronological record of all transactions executed on it and of all transactions reported to it. In it, it shall in particular record the time of the transaction, the dealers who participated therein, the securities traded, the number or nominal value of the securities traded and the price.

³ The stock exchange shall ensure that all information necessary to maintain a transparent market is made public; this shall apply, in particular, to the prices at which securities have been traded, the volume of securities traded both on and off exchange, and the companies which are not subject to the obligation to make an offer pursuant to Articles 32 and 52 or for which the threshold has been raised above 33 ⅓ percent.

Art. 6 Market Supervision

¹ The stock exchange shall supervise price formation, execution and settlement of transactions in such a manner so as to ensure that insider trading, price manipulation and other breaches of law may be detected.

² Whenever there is a suspicion of any breach of law or exchange regulations or any other irregularities, the stock exchange shall inform the Supervisory Authority. The Supervisory Authority shall order the necessary investigations

Art. 7 Admission of Securities Dealers

The stock exchange shall issue regulations regarding the admission, duties and expulsion of securities dealers, which regulations shall reflect, in particular, the principle of equal treatment.

Art. 8 Admission of Securities

¹ The stock exchange shall issue regulations regarding the admission of securities to listing.

² The regulations shall contain provisions relating to the negotiability of securities and shall set out the information which shall be furnished to investors in order to enable them to form an opinion about the characteristics of the securities and the quality of the issuer.

³ The stock exchange shall take into account internationally recognized standards.

⁴ The stock exchange shall admit securities to listing upon the fulfillment of the conditions set out in the regulations.

Art. 9 Appeal Board

¹ The stock exchange shall set up an independent appeal board with which an appeal may be lodged regarding the rejection of an application for admission

as a securities dealer or for the listing of securities or the expulsion of a securities dealer or the delisting of a security. The stock exchange shall set out rules governing the organization and procedures of such board.

² The organizational structure, the rules of procedure and the nomination of members shall be subject to the approval of the Supervisory Authority.

³ The right to civil action, which may be taken only after the appeal procedure has been exhausted, remains reserved.

Chapter 3: Securities Dealers

Art. 10 Authorization

¹ Whosoever intends to carry out the activities of a securities dealer shall be subject to authorization by the Supervisory Authority.

² Authorization shall be granted if:

- a. the organization and internal rules of the applicant are such as to ensure compliance with the duties under this Act;
- b. the applicant has the required minimum capital or has provided the required security;
- c. the applicant and its senior staff can show that they have the required professional knowledge; and
- d. the applicant, its senior staff and the principal shareholders can give an assurance of proper business conduct.

³ The Federal Council shall set the minimum requirements for authorization to be granted. It shall, in particular, set the minimum capital requirement in respect of legal entities and the amount of the security required in respect of natural persons and partnerships.

⁴ The Federal Council shall set out the conditions for authorization to be granted to securities dealers who intend to operate in Switzerland but have neither a registered office nor a branch here.

⁵ If a securities dealer is part of a group operating in the financial sector, the Supervisory Authority may require adequate supervision of the group on a consolidated basis by the foreign supervisory authorities as well as their approval for the setting-up of such dealer's operations in Switzerland.

⁶ In the event that the conditions for such authorization are altered subsequently, the securities dealer shall seek the approval of the Supervisory Authority for the continuation of its operations.

⁷ Only natural persons, legal entities or partnerships which have received authorization from the Supervisory Authority to operate as securities dealers may use the term "securities dealer" in their company name or in the description of their business purpose or in any business advertisement.

Art. 11 Rules of conduct

1 A securities dealer has vis-à-vis his clients:

- a. a duty of disclosure; he shall in particular inform them of the risks associated with certain types of transactions;
- b. a duty of diligence; he shall in particular ensure the best possible execution of his clients' orders and that they are able to retrace the steps taken in the execution of their orders;
- c. a duty of loyalty; he shall ensure that in the event of any potential conflict of interests his clients interests are not adversely affected.

2 In discharging these duties the clients' business expertise and professional knowledge shall be taken into account.

Art. 12 Own funds

1 A securities dealer must have a sufficient amount of own funds available.

2 The Federal Council shall set out the minimum own funds requirement, taking into account the risks associated with a securities dealer's operations, including off-balance sheet transactions. The Federal Council shall determine the extent to which banks must also meet the minimum own fund requirement.

Art. 13 Spreading of risk

1 A securities dealer must spread his risks in a manner appropriate to the risks involved.

2 The Federal Council shall set the limits of such risks and the add-ons to the own funds necessary to cover them and shall determine the extent to which such rules are applicable to banks.

Art. 14 Consolidation

A securities dealer shall comply with the provisions on own funds and the spreading of risk on a consolidated basis if it constitutes an economic unit with one or more other companies operating in the financial sector or if for any other reason it appears that the securities dealer is under a legal duty or in actual fact compelled to assist such other company.

Art. 15 Daily record and reporting requirements

1 The securities dealer shall keep a daily record of orders received and of transactions carried out, in which all information necessary to enable the reconstruction of the transactions and the supervision of his operations shall be recorded.

2 The securities dealer must report all the information necessary to ensure a transparent market.

³ The Supervisory Authority shall determine the type of information to whom it shall be reported and the manner in which it shall be communicated.

⁴ The Federal Council may impose the reporting requirement pursuant to para. 2 upon persons and companies which buy and sell securities in a professional capacity but without using a securities dealer when the objective of this Act so requires. Any such company must instruct recognized auditors to examine as to whether the reporting requirement is complied with; the company must provide the Supervisory Authority with the information it requires.

Art. 16 Accounts

¹ The securities dealer shall prepare annual accounts and publish them or make them available to the public.

² The accounts shall be prepared in accordance with the provisions of the law on joint stock companies, subject to any derogations by the Federal Council.

³ The Federal Council may set out detailed rules for the layout of the annual accounts, may require supplementary information to be provided in the notes to the annual accounts, may require the preparation and publication of interim results and balance sheets and may impose a duty to prepare consolidated accounts.

⁴ Banks shall be subject to the provisions of the Federal Act on Banks and Savings Institutions ¹⁾.

Art. 17 Audit

¹ The securities dealer is required to have his operations examined annually by recognized auditors. Such auditors shall also be at liberty to carry out interim audits without notice.

² It shall afford the auditors access to all such documents as may be necessary for their audit, and shall furnish them with all the information needed in the discharge of their audit duties.

³ The costs of the audit shall be borne by the securities dealer.

Art. 18 Auditors

¹ Only recognized bank auditors or an auditing firm recognized by the Supervisory Authority as auditors for securities dealers may be appointed to carry out an audit. The Ordinance shall set out the conditions for such recognition.

² Such recognized auditors themselves may not be securities dealers.

³ The auditors shall be independent of the Board of Directors and the management of the securities dealer whose operations are to be audited.

1) SL 952.0

Art. 19 Duties of the auditors

1 The auditors shall verify that the securities dealer has fulfilled his legal obligations and that he has complied with the requirements for authorization and his own internal regulations.

2 The auditors shall draw up a report on the results of the audit and shall forward such report to the audited securities dealer and the Supervisory Authority.

3 The Supervisory Authority shall issue rules relating to the scope of the audit and the contents of the audit report.

4 If the auditors, in the course of the annual or an interim audit, discover any breach of legal provisions or any other irregularity, they shall set a reasonable time-limit within which the securities dealer must rectify the matter and they shall add an appropriate comment to this effect in the audit report.

5 The auditors shall forthwith notify the Supervisory Authority in the event that:

- a. the deadline set pursuant to para. 4 has not been met;
- b. the auditors are of the opinion that it would serve no purpose to set such a deadline; or
- c. the auditors discover any breach of criminal law or serious irregularities

6 The auditors shall keep confidential all information which has come into their possession in the course of their audit, except in their dealings with the Supervisory Authority.

Chapter 4: Disclosure of Shareholdings in Listed Companies**Art. 20 Obligation to disclose**

1 Whosoever, directly, indirectly or in concert with third parties, acquires or sells, for his own account, in a company incorporated in Switzerland whose equity securities are listed, in whole or in part in Switzerland and thereby attains, falls below or exceeds the threshold percentages of 5, 10, 20, 33 $\frac{1}{3}$, 50 or 66 $\frac{2}{3}$ of the voting rights, whether or not such rights may be exercised, shall be obliged to notify the company and the stock exchanges on which the equity securities in question are listed.

2 The conversion of participation or bonus certificates into shares and the exercise of conversion or share acquisition rights shall be considered to be an acquisition for the purposes of this Act.

3 A group organized pursuant to an agreement or otherwise shall comply with the obligation to notify of para. 1 as a group and shall disclose:

- a. its total holdings;
- b. the identity of its members;
- c. the nature of the agreement; and
- d. the identity of its representatives.

⁴ If a company or a stock exchange has reason to believe that a shareholder is in breach of the obligation to notify, it shall inform the Supervisory Authority of such fact.

⁵ The Supervisory Authority shall issue rules relating to the scope of the obligation to notify, the treatment of share acquisition rights, the calculation of voting rights as well as the time limits within which the obligation to notify must be met and the companies must publish changes in the ownership of their shares pursuant to para. 1. The Takeover Board (Art. 23) shall have the right to put forward proposals.

⁶ Whosoever intends to acquire securities may obtain a ruling from the Supervisory Authority as to whether it will be subject to the obligation to notify.

Art. 21 Duty of the company to inform

The company shall be obliged to publish the information which it receives in respect of changes in the voting rights.

Chapter 5: Public Takeover Offers

Art. 22 Scope of the Act

¹ The provisions of Chapter 5 (Arts. 22–33) and Articles 52 and 53 shall apply to public takeover offers for holdings in Swiss companies whose equity securities are, in whole or in part, listed on an exchange in Switzerland (“offeree companies”).

² Companies may, prior to their equity securities being admitted to official listing on a stock exchange in accordance with para. 1, state in their articles of association that an offeror shall not be bound by the obligation to make a public offer pursuant to Articles 32 and 52.

³ A company may at any time adopt a provision pursuant to para. 2 in its articles of association, provided that this does not prejudice the interests of shareholders within the meaning of Article 706 of the Swiss Code of Obligations¹⁾.

Art. 23 Takeover Board

¹ The Supervisory Authority shall after consulting the stock exchanges, appoint a commission for public takeover offers (“Takeover Board”). This

1) SL 220

Takeover Board shall consist of expert representatives of securities dealers, listed companies and investors. The organizational structure and procedures of the Takeover Board shall be submitted to the Supervisory Authority for approval.

² The rules which are to be issued by the Takeover Board pursuant to this Act shall be submitted to the approval of the Supervisory Authority.

³ The Takeover Board shall, in each case, ensure compliance with the rules applicable to public takeover offers. The Takeover Board may demand from offerors and offeree companies all information and documents which it may require. It may issue recommendations to the persons concerned and may publish such recommendations.

⁴ In the event that its recommendations are rejected or not complied with, the Takeover Board shall inform the Supervisory Authority. The latter may render a decision on the matter.

⁵ The stock exchanges shall bear the costs of the Takeover Board. The Takeover Board may levy fees on the offerors and offeree companies.

Art. 24 Duties of the offeror

¹ The offeror shall publish the offer in a prospectus containing true and complete information.

² The offeror shall treat all holders of equity securities of the same class equally.

³ The offeror's obligations shall be incumbent upon all who act in concert with the former.

Art. 25 Review of the offer

¹ The offeror shall, prior to publication, submit the offer to an auditor recognized by the Supervisory Authority or to a securities dealer for review.

² The reviewing entity shall verify that the offer is in conformity with the law and the implementing provisions.

Art. 26 Right of rescission of the seller

The seller may repudiate a contract or rescind an executed sale if such contracts were concluded or fulfilled pursuant to a prohibited offer.

Art. 27 Announcement of the results of an offer and extension of the offer period

¹ The offeror shall publish the results of the public takeover offer upon expiry of the offer period.

² In the event that the conditions of the offer are met, the offeror shall be under an obligation to extend the offer period for those holders of shares and other equity securities who have not yet accepted the offer.

Art. 28 Additional rules

The Takeover Board shall set out additional rules relating to:

- a. the announcement of an offer prior to its publication;
- b. the contents and the publication of the prospectus as well as the conditions of the offer;
- c. the rules of fairness applicable to public takeover offers;
- d. the review of the offer by an auditor or a securities dealer;
- e. the offer period and any extension thereof, the conditions under which the offer may be withdrawn or modified and the period within which a seller may withdraw;
- f. actions taken in concert with third parties.

Art. 29 Duties of the offeree companies

¹ The board of directors of the offeree company (Art. 22 para. 1) shall submit a report to the holders of equity securities setting out its position in relation to the offer. The information provided by the offeree company shall be true and complete. The board of the offeree company shall publish such report.

² From the moment an offer is published until the result is announced, the board of directors of the offeree company shall not enter into any legal transactions which would have the effect of altering significantly the assets or liabilities of the company. Decisions taken by the general meeting of shareholders are not subject to this restriction and may be implemented irrespective of whether they were adopted before or after publication of the offer.

³ The Takeover Board shall issue rules concerning the report to be issued by the board of the offeree company and any measures which are directed, in an improper manner, at frustrating an offer or preventing it from being successful.

Art. 30 Competing offers

¹ If competing offers are made for the equity securities of the offeree company, the holders of equity securities in the offeree company must be free to choose which offer they accept.

² The Takeover Board shall issue rules relating to competing offers and their effect upon the first offer.

Art. 31 Obligation to notify

1 The offeror or whosoever has, directly or indirectly or acting in concert with third parties, holdings which give him at least 5 percent of the voting rights of the offeree company, whether or not such rights may be exercised (or, as the case may be, of another company whose equity securities are being offered in exchange) shall, from the time an offer is published until the expiry of the offer period, be obliged to notify the Takeover Board and the stock exchanges on which the securities are listed of any acquisition or sale of equity securities of such company.

2 A group organized pursuant to an agreement or otherwise shall comply with the obligation to notify referred to in para. 1 as a group.

3 The Takeover Board may subject any person to the same obligation which, from the time an offer is published until the expiry of the offer period, purchases or sells, directly, indirectly or acting in concert with third parties, a certain percentage of the equity securities of the offeree company or of another company whose equity securities are being offered in exchange.

4 In the event that the company or the stock exchanges have reason to believe that a shareholder is in breach of his obligation to notify, they shall inform the Takeover Board of such fact.

5 The Takeover Board shall issue rules as to the form and time limit allowed for notification and as to the percentage relevant for the application of para. 3.

Art. 32 Obligation to make an offer

1 Whosoever, directly, indirectly or acting in concert with third parties, acquires equity securities which, added to equity securities already owned, exceed the threshold of 33 1/3 percent of the voting rights of an offeree company (whether or not such rights may be exercised) shall be under an obligation to make an offer to acquire all listed equity securities of the company. An offeree company may raise this threshold in its articles of association to 49 percent of the voting rights.

2 In justified cases, the Supervisory Authority may grant exemptions from the obligation to make an offer, in particular:

- a. where the transfer of voting rights occurs within a group organised pursuant to an agreement or otherwise. In such a case, only the group as such shall be subject to the obligation to make an offer;
- b. where the threshold is exceeded as a result of a decrease in the total number of voting rights of the company;
- c. where the threshold is exceeded only temporarily;
- d. where the securities have been acquired without consideration or on exercise of pre-emptive rights pursuant to a share capital increase;

- e. where the securities have been acquired for reorganization purposes.
- ³ The obligation to make an offer shall not apply if the voting rights have been acquired as a result of a gift, succession or partition of an estate, a transfer based upon matrimonial property law or execution proceedings.
- ⁴ The price offered shall be at least as high as the stock exchange price and shall not be lower than 25 percent of the highest price paid by the offeror for equity securities of the offeree company in the preceding twelve months.
- ⁵ If the offeree company has issued several classes of equity securities, there must be an appropriate relationship among the prices offered for the various classes of equity securities.
- ⁶ The Supervisory Authority shall issue rules relating on the obligation to make an offer. The Takeover Board shall have the right to put forward proposals.
- ⁷ At the request of the Supervisory Authority, the offeree company or one of its shareholders, the court may by way of an interim relief suspend the voting rights of any person who is in breach of the obligation to make an offer.

Art. 33 Cancellation of outstanding equity securities

- ¹ An offeror, who upon expiry of the offer period, holds more than 98 percent of the voting rights of the offeree company may, within three months petition the court to cancel the outstanding equity securities. For this purpose, the offeror shall commence an action against the company. The remaining shareholders may participate in these proceedings.
- ² The company shall reissue such equity securities and allot them to the offeror either against payment of the offer price or fulfillment of the exchange offer in favour of the holders of the equity securities which have been cancelled.

Chapter 6: Supervisory Authority

Art. 34 Organization

The Federal Banking Commission shall be the Supervisory Authority ("the Supervisory Authority"). The organization shall be structured in accordance with Article 23 of the Federal Act on Banks and Savings Institutions¹⁾.

Art. 35 Duties

- ¹ The Supervisory Authority shall take such decisions as may be necessary to implement this Act and its implementing provisions and it shall supervise compliance with the legal and regulatory provisions.
- ² Persons and companies which are subject to supervision shall provide the Supervisory Authority with all information and documents which the latter may

1) SL 952.0

request in order to carry out its duties. Additionally, this obligation shall apply to:

- a. persons who hold a significant financial interest in a stock exchange or a securities dealer;
- b. auditors;
- c. persons and companies which are subject to a duty of disclosure;
- d. offerors in public takeover offers;
- e. offeree companies.

³ In the event that the Supervisory Authority becomes aware of any breach of the Act or any other irregularity it shall take all measures necessary to restore proper conditions and remove any irregularities. It shall issue such decrees as may be necessary to this effect. The Supervisory Authority may:

- a. suspend temporarily a securities dealer from engaging in any legal transactions and making payments as well as receiving payments in the event of imminent threat to the interests of his creditors;
- b. prohibit temporarily or permanently any person who as an employee of a securities dealer who is in serious breach of their duties under this Act, its implementing provisions or their internal regulations from trading in securities.

⁴ If an enforceable decree of the Supervisory Authority has, after formal notice has been given, not been complied with within the time limit set, the Supervisory Authority may, pursuant to para. 2, itself carry out the actions decreed; the defaulting persons or companies shall bear the costs of such action.

⁵ In the event of a refusal to obey an enforceable decree of the Supervisory Authority, the Supervisory Authority may publish such decree in the Swiss Official Commercial Gazette (SOCG) or otherwise make it public in any other form. If such a measure is to be taken, formal notice of such intent must first be given

⁶ If the Commission becomes aware of any criminal acts it shall forthwith notify the competent authorities for criminal prosecution. These authorities are under a duty to provide mutual legal assistance.

Art. 36 Withdrawal of authorization

¹ The Supervisory Authority shall withdraw the authorization of a stock exchange or a securities dealer if it no longer fulfills the conditions of such authorization or it is in serious breach of its legal duties or internal regulations

² Upon the withdrawal of authorization, legal entities and partnerships shall be dissolved and, in the case of sole proprietorships, their registration in the Commercial Register shall be cancelled. The Supervisory Authority shall appoint

a liquidator and supervise his activities. The Supervisory Authority may resolve not to order the dissolution of securities dealers which are also subject to the Federal Act on Banks and Savings Institutions¹⁾, provided that their banking licence does not also have to be withdrawn.

Chapter 7: International Relations

Art. 37 Authorization of foreign stock exchanges and securities dealers

Authorization of a foreign stock exchange or of a stock exchange controlled by foreign domiciles may be refused if the country in which the foreign stock exchange is located or the controlling foreign persons are domiciled does not afford Swiss stock exchanges genuine access to its markets and does not offer them the same competitive opportunities as it does to the local stock exchange. The same rule shall apply for the authorization of securities dealers.

Art. 38 Administrative Assistance

¹ The Supervisory Authority may request from foreign supervisory authorities in charge of stock exchanges and securities dealers such information and documents as may be necessary for the enforcement of this Act.

² It may forward publicly inaccessible information and documents to foreign supervisory authorities only if the said foreign authorities:

- a. use such information exclusively for the purpose of direct supervision of the stock exchanges and the trading in securities;
- b. are bound by official or professional secrecy; and
- c. do not, without the prior consent of the Swiss Supervisory Authority or by virtue of a general authorization clause in an international treaty, forward such information to competent authorities and to other bodies which carry out supervisory functions in the public interest. Forwarding information to criminal authorities is not permitted if mutual assistance in criminal matters would be excluded. The Supervisory Authority shall decide in consultation with the Federal Office for Police matters.

³ The Federal Act on Administrative Proceedings²⁾ shall be applicable insofar as the information to be forwarded by the Supervisory Authority concerns the clients of a securities dealer. It shall not be permitted to forward any information on persons who are manifestly not involved in the subject matter of the investigation.

1) SL 952.0

2) SL 172.021

Chapter 8: Appeal Procedure

Art. 39

There shall be a right of appeal in administrative matters to the Federal Supreme Court against the decrees issued by the Supervisory Authority.

Chapter 9: Penal Provisions

Art. 40 Operations without authorization

Whosoever intentionally:

- a. operates a stock exchange without authorization;
 - b. engages in the business of a securities dealer without authorization,
- shall be punished with a fine of up to CHF 200,000.

Art. 41 Breach of obligations to notify

¹ Whosoever intentionally:

- a. fails to notify a qualified shareholding in a listed company (Art 20 and 51);
 - b. as the owner of a qualified shareholding in the offeree company (Art 31), fails to disclose the purchase or sale of equity securities of that company,
- shall be punished with a fine.

² The amount of the fine shall not be more than double the purchase price or the sale proceeds. The amount of the fine shall be calculated based upon the difference between the new shareholding held by the person who is subject to an obligation to notify and the last shareholding declared.

³ Whosoever intentionally or negligently breaches the reporting obligation to which he is subject pursuant to Article 15 shall be punished with a fine of up to CHF 50,000.

Art. 42 Breach of duty by the offeree company

Whosoever intentionally:

- a. fails to submit a report to the holders of equity securities setting out his position in relation with the offer or fails to publish such report (Art 29, para. 1);
- b. includes untrue or incomplete information in such report (Art. 29, para. 1),

shall be punished with a fine of up to CHF 200,000.

Art. 43 Breach of professional secrecy

1 Whosoever:

- a. discloses a secret which has been confided to him in his capacity as a member of a governing body, employee, mandatary or liquidator of a stock exchange or a securities dealer, as a member of one of the governing bodies or employee of recognised auditors, or of which he has become aware in any such capacity; or
 - b. attempts such breach of professional secrecy by inducement,
- shall be punished by imprisonment or with a fine.

2 Whosoever breaches professional secrecy after termination of office or his employment, shall nevertheless remain liable to punishment.

3 The federal and cantonal provisions relating to the duty to testify and the duty to provide information to the authorities remain reserved.

Art. 44 Penal prosecution

1 The provisions of Part Two of the Federal Act on Penal Administrative Law¹⁾ shall be applicable to offences within the meaning of Articles 40, 41 and 42.

2 The Federal Department of Finance shall be the authority responsible for prosecution and adjudication pursuant to the provisions of Penal Administrative Law.

3 The cantons shall be responsible for the prosecution and adjudication of any breaches of Article 43.

Chapter 10: Final Provisions

Art. 45 Implementing provisions

The Federal Council shall issue implementing provisions to this Act.

Art. 46 Amendment to the Penal Code

The Swiss Penal Code²⁾ shall be amended as follows:

Art. 161 bis

Price manipulation Whosoever with the intent of significantly influencing the price of securities traded on a Swiss stock exchange in order to procure for himself or for a third party an unlawful gain: spreads misleading information which he knows to be misleading or purchases and sells such securities whereby the sale and

1) SL 313.0

2) SL 311.0

purchase directly or indirectly are entered into for the account of the same person or persons linked together for that purpose, shall be punished by imprisonment or with a fine.

Art. 47 Amendment to the Banking Act

The Federal Act on Banks and Savings Institutions¹⁾ shall be amended as follows:

Article 23, para. 1, 2, 4 and 5

1 The Federal Council shall elect a Federal Banking Commission consisting of 7–11 members, from which its president and the vice president(s) shall be appointed. This Commission shall be responsible for the supervision of the banking system, investment funds, stock exchanges, the disclosure of significant shareholdings and of public takeover offers, and shall have full authority over such matters. The Commission shall maintain a permanent secretariat

2 The Commission, which may be subdivided into several chambers, shall issue regulations concerning its organization and management, which shall be submitted to the Federal Council for approval.

4 The costs of the Commission and its secretariat shall be covered by fees. The Federal Council shall set out the details.

5 The members of the Commission must be experts in the field. Such members may not be a president, vice-president, delegate or member of the committee of the board of directors nor a member of the management of a bank, of an investment fund, of a stock exchange, of a securities dealer, or of a recognized auditor.

Art. 48 Cantonal laws

1 Upon the coming into force of this Act, any cantonal provisions restricting the right to establish new stock exchanges shall be repealed.

2 The cantonal provisions relating to securities trading shall cease to be applicable to stock exchanges or securities dealers which have been granted authorization under this Act.

3 The cantonal provisions relating to stock exchanges shall be repealed within one year and the cantonal provisions relating to securities dealers shall be repealed within three years of the coming into force of this Act.

Art. 49 Transitional provisions relating to stock exchanges

1 Existing stock exchanges shall report to the Supervisory Authority within three months of the coming into force of this Act and submit their internal regulations to it.

1) SL 952.0

² The Supervisory Authority shall, in principle, take a decision with respect to authorization within one year of the coming into force of the Act.

Art. 50 Transitional provisions relating to securities dealers

¹ Existing securities dealers shall report to the supervisory authority within three months from the coming into force of this Act, and shall comply with the requirements set out in the Act within two years of its coming into force. The Supervisory Authority may on a case-by-case basis extend or shorten this period if special circumstances so require.

² The Supervisory Authority shall, in principle, take a decision with respect to authorization within three years of the coming into force of this Act.

³ Any foreign person or foreign-controlled securities dealer which was admitted to a Swiss stock exchange on December 31, 1992 shall not be subject to the reciprocity requirement set out in Article 37.

Art. 51 Disclosure of shareholdings in listed companies

Whosoever, upon the coming into force of this Act, holds a shareholding which gives him at least 5 percent of the voting rights of a joint stock company incorporated in Switzerland whose equity securities are listed on a stock exchange, shall, within three years, notify such shareholding to the company and to any stock exchange on which the equity securities are listed.

Art. 52 Obligation to make an offer

Whosoever, upon the coming into force of this Act, owns directly, indirectly or acting in concert with third parties equity securities which give him more than 33 ⅓ percent but less than 50 percent of the voting rights of an offeree company, shall, if he acquires equity securities and thereby exceeds the threshold of 50 percent of the voting rights, be under an obligation to make an offer to acquire all the equity securities listed.

Art. 53 Obligation to make an offer for companies already listed

Companies which are already listed on a stock exchange may, within two years of the coming into force of this Act, adopt a provision in their articles of association in accordance with Article 22 para. 2. In such a case, Article 22 para. 3 shall not be applicable.

Art. 54 Cancellation of outstanding equity securities

¹ Whosoever, upon the coming into force of this Act, holds, as a result of a previous public takeover offer, more than 98 percent of the voting rights of a company may, within six months of the coming into force of this Act, apply for a cancellation of the outstanding equity securities pursuant to Article 33.

2 The owners of equity securities which have been cancelled shall be entitled to a fair price which shall be calculated based upon a report by the auditors

Art. 55 Referendum and coming into force

1 This Act is subject to an optional referendum.

2 The Federal Council shall determine the date upon which this Act shall enter into force.

**Concluding Observations: The New Financial
Architecture and the Possible Implications for
the University of Hong Kong
Faculty of Law**

Professor Joseph J. Norton

*The attached pages were prepared by Professor Norton and Mr. Arner as a chapter in an upcoming edited volume being prepared by Professor Raymond Wacks of the University of Hong Kong Law Faculty in celebration of the Faculty's 30th Anniversary

**Internationalisation of Public Financial Law in Hong Kong:
A New Dimension for the HKU Faculty of Law's Curriculum**

Joseph J. Norton* & Douglas W. Arner**

I. Introduction

Public financial law¹ in Hong Kong (as has typically been the case throughout the world) has developed in response to crises. This chapter will address the development of two key components of public financial law in Hong Kong over the past decade: banking regulation and capital market regulation. While Hong Kong has not always had effective systems of financial regulation, it has been steadily strengthening its regulatory framework both for financial institutions and for the securities markets.² The increasing effectiveness of its legal and institutional regulatory framework has enhanced its development as an international financial centre over the past ten years and will be vital to its continued success over the next ten and beyond.

According to one commentator, public financial law in Hong Kong has undergone three stages of development.³ Respecting banking regulation, these are: the “dark age” (1841 to 1964), the “medieval age” (1962 to 1985), and the modern age of globalisation and international standards (1986 to the present).⁴ Respecting capital market regulation, these are: the “dark age” (1841 to 1973), the “medieval age” (1974 to 1987), and the modern age of globalisation and international standards (1987 to the present).⁵

While these generalised periods of the development of banking and capital market regulation are not exactly coextensive, the period from 1986 has been one of strengthening of regulation and supervision of financial institutions and markets, with the overriding goal of achieving “international standards”. We would suggest further that the period from 1986 to 1995 was really a period of modernisation and search for best practices, not only in Hong Kong but world-wide. Moreover, the period since the Mexican financial crisis in 1994-95 has seen the beginning of a new period centred on the establishment of minimum internationally acceptable standards of public financial law through a process centred on the Group of Seven, the Group of Ten, what may be

called the “international financial organisations”, and the traditional “international financial institutions”

Following the financial crises in Asia, Russia and Brazil of the past two years, attention has focused even more on the importance of developing such standards and upon their implementation into domestic legal systems and regulatory and supervisory practices. In Hong Kong, this is an on-going process which is likely to shape the development of public financial law in both the SAR and the Mainland significantly over the next ten years, and to a greater extent even than the previous ten. With the development of this new public financial law comes the need for law Faculties, especially in Hong Kong, to adjust and train the next generation of lawyers and scholars to understand and influence the on-going process of the development and implementation of international standards of public financial law.

II. Modernisation and Internationalisation of Public Financial Law 1986-97

A. The Backdrop

Prior to the 1970s, many governments and financial market regulators operated on the premise that financial market stability required limitations on competition and a segmented market structure that segregated international banks, securities firms, and insurance companies. In particular, the perception of the banking and securities industries as separate and distinct generally eased the supervisory oversight of these industries. This has occurred principally due to the clearly delineated and understood legal and market distinctions between these different types of financial institutions.⁶

However, in the late 1970s, and particularly in the 1980s and now the 1990s, technological and financial innovation began to facilitate competition within and across these industry segments. This initiated the process of regulatory adaptation to *de facto* changes in market structure and financial institutions. Restrictions on permissible activities were gradually relaxed and market access for domestic and foreign competitors expanded, resulting in net efficiency gains to the international financial system. Nonetheless, international banks still primarily engaged in traditional forms of intermediation, namely the business of taking money from investors and depositors and lending it to corporate and residential borrowers. Credit risk was the major risk incurred by these financial institutions, since interest rate risk

could be managed by ensuring that the contractual interest rate on the loaned funds varied with the cost of funds⁷

In the mid-1980s, in the midst of the Lesser Developed Country (LDC) sovereign debt crisis, the vulnerability of individual banks and the international financial system increased exponentially, and bank exposure to credit risk dominated the regulatory agenda⁸. The LDC debt crisis (which in fact transformed itself into a world debt crisis) led to international prudential efforts, centralised in the Basle Committee on Banking Supervision, to strengthen systemic defences to credit risk through the issuance of risk-based capital standards in the 1988 Capital Accord⁹. The Capital Accord focussed on the credit risk of international banks because such banks, as the main providers of payment services, were the primary inter-connective media of economic transactions, and because liquidity and credit exposures were naturally concentrated within the banking system. In addition, banks normally channelled the intermediation of short-term funds into long-term non-marketable assets, thus making banks more susceptible to credit risk and public confidence problems than other institutions.¹⁰

B. The New Operating Environment

In the past decade, traditional bank intermediation has changed dramatically. Large non-bank institutions (including securities firms, finance companies, insurance companies, pension funds and other collective funds and trusts) have become major players in the intermediation process and forced banks to expand their range of financial activities into the other previously segmented industries. Hence, in the 1990s, international banks have been significantly expanding the scope of their activities into areas that directly impact and/or reallocate credit risk, thereby exposing them to differentiating types of risk not previously under supervisory scrutiny¹¹.

The expansion of banks into non-traditional activities has spawned the realisation that financial risks could be desegregated, separately priced, and traded in global financial markets. This realisation is having important implications for international financial market supervision and regulation. Particular types of risk are no longer confined to specific institutional categories. As such, financial institutions have come to recognise that unbundled risks can be recombined in ways reflecting the risk profiles

of financial institutions that until recently have been characterised as separate and unique. This explosion of financial product innovation raised (and continues to raise) a host of new legal and practical issues (public and industry) that needed to be addressed within the expanding parameters of public financial law¹²

The recent Basle Committee amendments to credit risk-based capital requirements are of great importance to international financial institutions¹³ However, these amendments have been arguably overshadowed by the coordinated but unbalanced efforts of international banking supervisors and securities regulators towards regulatory convergence for similar activities and in certain areas of risk management, particularly market risk. Yet, the globalisation of financial activities leads inescapably to the reality of greater communication, cooperation, and coordination among bank supervisors and securities regulators on a broader, international basis¹⁴

C. Development of Public Financial Law in Hong Kong

Financial regulation in Hong Kong prior to the 1990s developed as post-hoc responses to serious financial crises. In fact, prior to the mid to late 1980s, Hong Kong essentially had no public financial law; rather, a tightly knit group of financial institutions largely regulated themselves as a sort of a “club”.¹⁵ According to a leading scholar, “[t]he banking crisis of 1982-1986 and the near bankruptcy of the futures market during the world stock market crash of October 1987, forced the authorities to undertake a far-ranging reform of the regulatory framework.”¹⁶

1. Banking regulation

Hong Kong did not adopt its first ordinance regulating banking operations (the Banking Ordinance 1948), until 1948. This remained largely unchanged (and rudimentary) until 1986. Following significant bank failures during the period of 1983 to 1986, the government enacted a new Banking Ordinance¹⁷ intended to provide comprehensive supervision of Hong Kong’s banks and deposit-taking companies for the first time. While the 1986 Ordinance largely reflected the Banking Act 1979 and Banking Act 1987¹⁸ that was then being developed in the U.K., its adoption signalled the beginning of Hong Kong’s search for international best practices in the area of banking regulation and supervision.

In the area of banking regulation, Hong Kong sought adoption and use of international standards. For example, the Basle Capital Accord of 1988¹⁹ was applied in Hong Kong since end-1989, with its internationally accepted minimum capital adequacy ratio of eight per cent²⁰. As an indicator of the success of its implementation, at end-December 1996, the consolidated capital adequacy ratio of all locally incorporated institutions in Hong Kong was 17.8 per cent²¹. In 1995, the Banking (Amendment) Ordinance²² was enacted in an effort to tighten certain loopholes existing in the 1986 ordinance.

In addition, the Hong Kong Monetary Authority (HKMA) was established and provided clear powers and responsibilities by the Hong Kong Government on 1 April 1993²³. With effect from that date, the former Office of the Commissioner of Banking was merged with the Office of the Exchange Fund to form the HKMA, with the functions of the former Commissioner since being subsumed under the HKMA²⁴. Under the Banking (Amendment) Ordinance 1995 enacted on 28 June 1995, the HKMA is now responsible for all authorisation matters, including authorisation, suspension and revocation of all three types of authorised institutions, namely licensed banks, restricted licensed banks and deposit-taking companies.²⁵

Section 5A was added to the Exchange Fund Ordinance²⁶ in 1992 to create the HKMA and give it authority to maintain, control, and manage the Exchange Fund and to carry out other functions assigned to it under various other ordinances, principally the Banking Ordinance.²⁷ Section 7(2)(a) of the Banking Ordinance provides that the HKMA shall be responsible for supervising compliance with the provisions of that ordinance, with a mandate to ensure the safety, stability and effectiveness of the Hong Kong banking system²⁸ and to maintain the stability of Hong Kong's currency by regulating the banking business and the business of taking deposits, by supervising authorised institutions, and by managing the Exchange Fund²⁹. The ordinance provides that the HKMA may issue guidelines stating how its statutory objectives are to be carried out.³⁰ In its regulatory efforts, the HKMA has developed an approach based on continuous supervision and achieves this through on-site examinations, off-site reviews, prudential reviews, and cooperation and information sharing with external agencies³¹.

Further, the HKMA has sought to follow international trends for best practice in the area of financial regulation as they develop³² For example, in January 1996, the Basle Committee issued proposals for applying capital charges to market risks incurred by banks³³ From 31 December 1996, the HKMA implemented a reporting framework on market risks, with the revised capital adequacy regime taking statutory effect by the end of 1997, in line with Basle requirements³⁴ The HKMA has also sought to follow international practice in regard to the supervision of international banking operations as embodied in the revised Concordat³⁵ In addition, the minimum standards for the supervision of international banking groups established by the Basle Committee in July 1992 have been taken into account in establishing the manner in which the authorisation criteria are applied to overseas applicants³⁶

As an indication of the significance of the role of the HKMA, at the end of 31 January 1996, there were 182 licensed banks, 62 restricted license banks and 124 deposit-taking companies in Hong Kong.³⁷ Of these 368 authorised institutions, 334 were owned by interests from over 30 foreign countries³⁸ In addition, there were 157 representative offices of foreign banks.³⁹ At the end of January 1996, there were 35 China-related authorised institutions, of which 18 were licensed banks⁴⁰ The Bank of China Group (BoC) had become the second largest banking group in Hong Kong, second only to the Hongkong Shanghai Banking Corporation (HSBC)⁴¹ Moreover, BoC became one of the three note-issuing banks in Hong Kong in 1994⁴² As a result, the People's Bank of China (PBC) (China's central bank) and the HKMA have been working closely together and have retained their separate responsibilities Further, the HKMA has retained its independence under the directorship of Joseph Yam, despite not being formally independent from the Treasury. Following resumption of Chinese sovereignty, the HKMA retains its role under the principle of "one country, two currencies, two monetary systems and two monetary authorities" that are mutually independent.⁴³

2. *Capital Market Regulation*

Prior to 1987, capital market regulation in Hong Kong was essentially non-existent While a Securities Commission, a Commodities Trading Commission and a Stock Exchange Compensation Fund had been created and numerous ordinances enacted to address securities regulation during the 1970s⁴⁴, the complete failure of the market in

October 1987 exposed the inadequacies of the then existing system⁴⁵ As a result of the crisis, the government commissioned the Securities Review Committee to develop a plan to upgrade Hong Kong securities market infrastructure to international standards in November 1987, which has since served as a blueprint for the modernisation of capital market regulation in Hong Kong⁴⁶

In the area of capital market regulation, Hong Kong made a sustained effort to develop its securities legal and financial infrastructure following the world-wide market collapse of 1987⁴⁷ While such regulation was not always given the attention that it deserved, the experience of the United States in developing its domestic capital markets after the 1929 Crash suggest that such regulation in the interests of investor protection and disclosure is essential to the development of capital markets of significant depth and liquidity⁴⁸ Efforts in this direction include the creation of the Securities and Futures Commission and the strengthening of the regulatory effectiveness of the Stock Exchange of Hong Kong (SEHK) and the Hong Kong Futures Exchange (HKFE). These efforts have enabled Hong Kong to become the second largest stock market in Asia, after Tokyo.

The Securities and Futures Commission (SFC) was established on 1 May 1989 under the Securities and Futures Commission Ordinance⁴⁹, pursuant to a recommendation by the Securities Review Committee. It is a statutory body responsible for regulating the securities and futures markets in the interests of investors through administration of the laws relating to the trading of securities, futures and forex contracts within in Hong Kong. The SFC has the duty of ensuring the enforcement of relevant provisions of the related ordinances, e.g. the Companies Ordinance⁵⁰, the Commodity Exchanges (Prohibition) Ordinance⁵¹, and the Securities (Disclosure of Interests) Ordinance⁵² It also has the responsibility to monitor implementation of the Exchanges (Special Levy) Ordinance⁵³

Since its initiation, it has sought to update existing ordinances, regulations and regulatory practices to internationally acceptable levels In 1991, both the Securities (Insider Dealing) Ordinance⁵⁴ and the Securities (Disclosure of Interests) Ordinance⁵⁵ were enacted, and in 1992, the Securities (Clearing Houses) Ordinance was enacted These ordinances are supported by various rules and codes, such as the Code on Unit

Trusts and Mutual Funds, the Code on Investment-linked Assurance and Pooled Retirement Funds, and the Code on Immigration-linked Investment Schemes, and the Codes on Take-overs and Mergers and Share Repurchases. In addition, in 1991, the SFC and the Stock Exchange of Hong Kong signed a Memorandum of Understanding Governing Listing Matters setting out the division of authority for supervision and regulation of listed companies and market professionals acting in the context of listed activities.

More recently, and also as a result of a Securities Review Committee recommendation, the SFC published in April 1996 a proposal to consolidate and rationalise eight existing ordinances into a single ordinance.⁵⁶

The Securities and Futures Commission (SFC) has been extremely active internationally, especially during the tenure of its former Chairman, Anthony Neoh, who acted concurrently as the Chairman of the Technical Committee of the International Organisation of Securities Commissions (IOSCO).⁵⁷ As a result, the SFC and Hong Kong have actively sought not only to implement international standards of best practice in its capital markets, but in fact to lead the development of those standards for the rest of the world. The SFC has been active in signing Memoranda of Understanding and similar cooperative agreements with securities and futures regulators around the world and is actively involved in the IOSCO.⁵⁸ Importantly, the SFC continues to be a full independent member of IOSCO.⁵⁹

III. An International Overlay: Principles and Standards of Public Financial Law

Following the Mexican financial crisis of 1994-95 and the US and international rescue operation that it required, leaders of industrial nations recognised the need to develop mechanisms to deal with the potentially systemic dangers of such financial crises.⁶⁰

In response to an initiative at the Lyon summit of the Group of Seven in June 1996, representatives of the countries in the Group of Ten and of emerging market and transition economies jointly sought to develop a strategy for fostering financial

stability through the analysis of key experiences in previous crises and to elucidate basic standards and principles to guide individual nations in the development of stronger financial systems⁶¹ The primary conclusion to emerge from this study was that a financial system that is robust is less susceptible to the risk of a crisis in the wake of real economic disturbances and is more resilient in the face of crises that do occur

A. The Standard Setting Process for Public Financial Law

As a result of the international attention to the requirements of sound financial systems, a number of international organisations were directed by the G-7 to develop agreed minimum principles and standards necessary to be implemented in order to encourage and improve confidence in and viability of domestic financial systems The aim of such standards is to promote sound financial institutions, to minimise systemic risk and to encourage savings and investment activity through increased confidence in financial markets, both domestically and internationally It must be noted at the outset however that these international principles and standards are just that. minimum internationally agreed guidelines that leave wide latitude in their implementation and effectiveness

The development of this emerging consensus on the requirements for financial stability can be seen to be the result of two separate series of events since the collapse of the Bretton Woods system in 1972 These series of events can be classified along two axes, one based on the experience of the developed economies and one based on experiences within emerging economies First, the growth of international cooperation and the establishment of minimum standards in the area of regulation of financial institutions has come to be viewed as essential in order to maintain and to strengthen the confidence and integrity of the international financial system This trend is reflected in the evolving role of the Basle Committee on Banking Supervision as a response to various crises involving international financial institutions since the 1970s and the increasing importance and effectiveness of its pronouncements in the area of financial institution regulation and supervision⁶² Further, international

cooperation in this area continues to be of increasing importance to the developed economies as financial technological innovation and internationalisation continues at a rapid rate, as demonstrated by recent intense focus on the areas of derivatives and payment and settlement systems throughout the world⁶³

The second strand of developing international consensus is the realisation of the importance of domestic financial stability for developing countries, especially given their potential vulnerabilities to changes in capital flows within the international financial system. In many ways, this emerging consensus is the result of the 1980s Debt Crisis and the Mexican Peso Crisis of 1994-95, which has since been echoed in an all too substantial form in Thailand, Indonesia, South Korea, Russia and Brazil⁶⁴. The consensus in this area is that in order to develop economically, emerging market countries must have in place appropriate structures to guarantee financial stability, especially given the increasing mobility of international capital and the reliance of emerging markets on that capital to fund their own development processes.⁶⁵

Public financial law is taking on an increasingly international overlay. Global consistency in the prudential regulation of the similar financial services and activities of international banks and securities firms can only be realised through enhanced initiatives in international supervisory coordination and cooperative information-sharing arrangements.⁶⁶ With respect to banking supervision, the Basle Committee has been the vehicle of international regulatory cooperation for banking supervisors and the driving force behind coordinated supervision for global markets. The Basle Committee has embraced the concepts of consolidated supervision and clear division of responsibilities between the home and host country supervisors for cross-border banking groups in this regard.⁶⁷

With respect to securities regulation, IOSCO⁶⁸ has been the collective forum for the development of international cooperation and information-sharing among securities regulators. Although IOSCO lacks the supervisory influence enjoyed by the G-10 members of the Basle Committee, the geographically broader-based IOSCO membership has issued several (in 1986, 1989, 1994, 1996 and 1998 respectively) resolutions on compliance with basic IOSCO principles on high regulatory standards, cooperation, and mutual assistance.⁶⁹ These IOSCO initiatives on international

coordination and cooperative information-sharing have been carried out largely on a bilateral basis between national securities regulators in the form of memoranda of understanding (MoUs) ⁷⁰

Enhanced joint undertakings by the Basle Committee and IOSCO have had, and should continue to have, a significant, positive influence on the international convergence, coordination, and information-sharing processes and the financial sector reform within developing, emerging and transitioning economies should reflect the continuing efforts of these two informal “international financial organisations”.

The conclusion from analyses of both the recent Barings and Daiwa episodes, and the various supervisory initiatives that followed, is that there needs to be improved coordination and cooperation among banking supervisors and securities regulators. This coordination may soon be achieved by a new panel of world financial regulators called the “Joint Forum” (comprised of officials from the Basle Committee, IOSCO and the International Association of Insurance Advisors (IAIS)), which has agreed to convene, on a regular basis, to address more definitively issues related to the supervision of international financial conglomerates ⁷¹

In sum, the degree of international regulatory coordination and cooperation is intensifying through the Basle Committee, IOSCO, IAIS, and Joint Forum processes in response to the globalisation of financial markets. The international coordination and cooperative information-sharing initiatives have been primarily led by supervisory authorities, and the private sector companies will need to accommodate these initiatives while ensuring the preservation of confidential information given to the regulators. The supervisory initiatives have been both bilateral and multilateral, and the geographic and institutional coverage has varied from specific rules to broadly drawn recommendations. This process is encouraging and needs to continue to develop.

B. Development of International Principles of Public Financial Law

Based on the need to establish prescriptive requirements for the sort of safe and efficient financial system that is essential for the functioning of any economy, the G-7 at their Lyon Summit in 1996, in the wake of the Mexican Peso Crisis of 1994-95,

directed the international financial institutions and organisations, especially the IMF, the World Bank and the Basle Committee on Banking Supervision, to develop standards for financial regulation to be implemented in both developed and developing countries, as well as to develop solutions for domestic crises with international implications, such as the Mexican Crisis⁷²

1. *Banking regulation*

In the area of banking regulation and supervision, the Basle Committee on Banking Supervision, composed of the G-10 central bank governors developed *Core Principles for Effective Banking Supervision and Regulation*.⁷³ In the *Core Principles*, the Basle Committee, in conjunction with regulators from 16 other jurisdictions including transitioning and emerging economies, has produced twenty-five basic principles that should underlie the banking supervisory policies and structures, present the basic outline for effective banking supervision and are intended to serve as a basic reference for supervisory and other public authorities in all countries and internationally. Detailed guidance in the implementation of the *Core Principles* is in turn provided through the Basle Committee's compilation of its on-going pronouncements over the years.⁷⁴

While Hong Kong has historically not had a good record of banking stability, a recent study concluded that the HKMA had learned from the problems of the 1980s and the BCCI affair in 1991.⁷⁵ According to an assessment by the HKMA, the Basle *Core Principles* have been implemented in and addressed by the regulatory framework for banking in the SAR.⁷⁶ Some however disagree with this assessment.⁷⁷ Nonetheless, it is clear that Hong Kong and the HKMA take the Basle *Core Principles* as the basis for evaluation of whether the system meets internationally acceptable standards for banking regulation and supervision. Further evidence can be found in the recent Code of Banking Practice issued in July 1997, covering fair banking practices, and reflecting the requirements of the then-draft *Core Principles*.

2. *Capital market regulation*

In the area of capital market regulation, IOSCO has taken the lead with its recent publication and adoption of *Objectives and Principles of Securities Regulation*.⁷⁸ In

addition, it has developed a framework for minimum content of public offer prospectuses⁷⁹ Finally, IOSCO, along with the IASC, is in the process of developing internationally acceptable accounting standards, with the hope of uniting the international financial system with a single language⁸⁰ These latter documents are intended to set a basic framework for international offering documents acceptable to regulators and stock exchanges around the world.

As noted above, the HKSFC was instrumental in the development of the IOSCO *Objectives and Principles*. While no clear evaluation of the present system of capital market regulation in Hong Kong comparing it to these standards has been published, the draft Securities and Futures Bill contains (not surprisingly) many similarities to the IOSCO document. Although the Bill has not been adopted, its contents continue to be implemented piecemeal, with the most recent example the proposed consolidation of the various financial exchanges in Hong Kong into a single entity.

IV. The Future of International Standards and Public Financial Law

The process of convergence is evolving through the concept of functional regulation (*i.e.*, the provision of similar regulatory and supervisory standards for similar activities that international banks and securities firms currently engage in on an increasingly cross-border basis). This concept is guiding banking supervisors and securities regulators (e.g., those in the PRC and Hong Kong SAR)⁸¹ to begin to jointly coordinate efforts in order to better understand the banking and securities businesses, the corporate structures and attendant risks involved in each business, and the increasing complexities of non-traditional cross-border activities⁸²

A. The New Forum

Within the banking and securities industries, much of the international consultation among bank supervisors in recent years has been effectively handled through the Basle Committee. For capital market concerns, IOSCO has offered a similar international forum⁸³ For the insurance area, there is emerging the IAIS⁸⁴ For the accounting industry, there is the International Accounting Standards Committee

("IASC").⁸⁵ What is even more significant is the growing cooperation among these various international bodies as to international standards setting. Of particular note is the work of the Joint Forum on Financial Conglomerates.⁸⁶

Though the international convergence of standards and perspectives of the Basle Committee and IOSCO have been able successfully to produce a number of guiding principles in financial market regulation, this has occurred in direct response to the increasing realisation that international banks and securities firms have the expertise and technological ability to engage in the full spectrum of financial activities and services anywhere in the world. Advances in telecommunications and computer technology provide banks and securities firms with new and more efficient opportunities to expand regionally, nationally, and globally in search of new financial activities, markets, and profits. In this respect, the combined utilisation of human expertise and technological innovation is resulting in intense international competition. This competition directs such institutions to seek out non-traditional risks in each respective business in pursuit of increased profits. Thus, the demarcation between banking and securities industries is becoming forever blurred, perhaps to the point where fundamental distinctions will no longer exist in some operational areas.⁸⁷

B. Non-traditional Systemic Risks

Public financial law should take into account the new risks within the financial system, as law can be used as a means for identifying and managing such risks. While financial innovations have provided new opportunities to operate efficiently and to manage and to control risks, they also created the potential for financial institutions to accumulate enormous losses in a short period of time. The recent failure of Barings Bank due to rapidly accumulated trading losses in exchange-traded derivatives is one most notable example of such intragroup contagion.⁸⁸ In addition, these innovations may also increase the possibility for non-traditional systemic risks that should be addressed by financial institutions and regulators together. These non-traditional systemic risks arise because enhanced linkages across national and international financial markets increase the volatility of capital flows and the potential for concentrated disturbances to be transmitted more broadly across institutional groups or markets. The increased linkages across markets and volatility in capital

flows may precipitate or trigger rapid intermarket contagion and thus systemic difficulties. The international ramifications from the Mexican liquidity crisis beginning in December 1994-February 1995 and the even more recent East Asian Financial Crises of 1997-1998 are glaring illustrations of this phenomenon⁸⁹

There are four principal non-traditional areas of potential systemic risk present in the international financial system today that need to be addressed by bank regulators. Though the full analysis of these risks is outside the scope of this chapter, it is useful to address each in turn. These risks can only be addressed appropriately by financial institutions and international regulators working together in quasi-symbiotic “partnerships”.

Firstly, there is the threat that a second sovereign debt crisis will arise because of developing country default on securitised debt obligations. These concerns are exacerbated by the widely dispersed holdings of these obligations among institutional investors and by the fact that the terms and conditions on instruments such as Brady Bonds are not conducive to sovereign debt reschedulings or restructurings.⁹⁰

Secondly, there is the dramatically increased exposure to foreign exchange payment and settlement risk, otherwise known as “Herstatt Risk”, underlined by the Bank for International Settlements (BIS) in a recent March 1996 report⁹¹. The fact that the multicurrency clearing systems currently in existence are not subject to regulatory oversight intensify concerns of such risks.

Thirdly, there is the potentially destabilising effect of money laundering by criminal syndicates on the international financial system. Money laundering “contagion” can possibly arise as a systemic risk if financial institutions or financial communities (such as those in certain Latin American countries, Russia and Eastern Europe, or in China) are overcome with criminal influence and saturated with laundered funds. In short, the interests of international criminal syndicates may not exactly promote the preservation of the stability of the international financial system. If the influence of these groups permeates financial institutions or communities, any aspect of the international financial system could be at risk if financial obligations are ignored or institutions and governments become corrupted.⁹²

Fourthly, there is non-sovereign-related “cross-border financial crises contagion risk”, as most recently evidenced by the East Asian Financial Crises. Addressing this fundamental problem, it has become clear that the “New Financial Architecture” will need to be heavily “law-based”⁹³

Notwithstanding these potential systemic risks, continued legislative or regulatory attempts to maintain segmented regulation between international banks and securities firms will only serve to shift activities to more favourable jurisdictions within the global financial community. In effect, the process of international regulatory convergence in banking supervision and securities regulation is not an attempt to restrict expansion into new activities or competition among financial institutions. Rather, the process is being driven internationally so that regulators may “catch up” with modern international financial market developments, which are coming about with an almost unnerving speed as a result of the accelerated rate of technological innovation.⁹⁴

Thus, technologically driven market reforms are precipitating revolutionary changes within the banking and securities industries on an international basis. In turn, changes in the methods by which international financial institutions should be supervised and/or regulated are being engendered. These changes are already happening to some degree on the international spectrum. This technological dimension is also something of key importance that will have to be factored into any future efforts in addressing economic and financial law crises.⁹⁵

The process of international convergence, however, has occurred (up to now) largely in a piecemeal and disorganised manner. Nonetheless, the convergence process assuredly marks the transition from fragmented, nationally-based regulatory arrangements in the banking and securities industries towards a system of international principles and standards. These principles will be applied in a functionally integrated global financial services industry that will encompass both banking and securities businesses, and will have to be assimilated into any “rethinking” public financial law – perhaps as a species or subset of economic law

V. Public Financial Law in Hong Kong: The Next Ten Years

It has become evident, particularly with the recent Asian Financial Crises, that issues of economic and commercial law reform are of primary political and societal concern. The sustainability of economic growth, of enhancement of the quality of life, and of the stability of the economic and financial systems must be a driving imperative for the 21st Century for all economic systems, whether lessor developed, developing, emerging or transitioning or industrialised. All this will require viable (and “safe and sound”) financial and commercial law systems of considerable sophistication and of high integrity and transparency.⁹⁶

Moreover, it has become apparent since the breakdown of the Bretton Wood's (International Monetary) System in the early 1970s that financial markets around the world have become and are becoming more and more interconnected and interdependent. As such, many countries, especially developing, emerging, and transitioning economies are finding themselves in a state of major transformation as to the nature and requirements of their economy and its financial markets. The modern reality is that political and economic power comes, in part, from developing and sustaining viable and substantial economic and financial markets – markets that are becoming increasingly internationalised.⁹⁷ Recent experiences of Hong Kong are clearly supportive of this proposition.⁹⁸

Several preliminary observations on the critical importance of the future development of financial law and regulation, and its relationship to the evolving notion of “economic law”, can be drawn from, particularly as to issues that will be subject to considerable external regional and international pressures. The recent financial crises in East Asia, Russia, Brazil and elsewhere bring this point home.⁹⁹

A first observation is that the relationship of law to financial markets and financial institutions is an evolving and diverse process entailing a rich matrix of *private* and *public* laws, of domestic, regional and international laws (including “soft law”) and a mix of statutes, administrative regulations and case law. This unfolding legal framework covers both traditional and segregated notion of particular type of financial institution and broader, more integrated notions of “financial services” and

“financial institutions”.¹⁰⁰ As such, “economic law” (domestic and international) will be a blend of private and public law. In all events, this developing area of law will need to become attuned and receptive to these dramatically and vastly changing notions, to the new legal and economic realities of the individual countries and to the general growing economic interdependence within the East Asia Region, and to the more general international financial market developments.¹⁰¹

A second related observation suggests that the future of domestic financial institutions and markets will and should continue to be influenced and shaped, in a significant measure, by external international and regional supervisory developments. These external pressures may well come to provide the strands for a gradual integration and convergence by “small-steps” respecting the financial systems and markets of individual sovereign nations, and otherwise (notwithstanding the current East Asian Financial Crises) should help foster, generally, greater transparency and stability in the financial markets in the domestically, regionally and internationally.¹⁰² Yet, all this needs to be effected with a system that embraces a strong “rule of law” and has sound constitutional underpinnings. Again, private and public law are “twinned”.

A. Financial Law in Hong Kong SAR

Under the provisions of the Basic Law, HONG KONG is to maintain its status as an international financial centre.¹⁰³ At present, Hong Kong is one of the leading international financial centres in the world: it is the fifth largest banking centre for external financial transactions, the fifth largest foreign exchange market, the seventh largest stock market, the eighth largest trading entity, and the busiest container port.¹⁰⁴ While HONG KONG is already a significant international financial centre, with the reunification with Mainland China it now has an advantage that it never had before and that has been essential to the development of the other world-class financial centres: access to one of the world’s largest economies and perhaps equally importantly one of the world’s highest savings rates.¹⁰⁵

Over the next decade, the SAR will have to continue to influence and implement developing international standards and principles in the area of public financial law, as well as updating its private financial law infrastructure. While the development and adoption of international principles is likely to lead to a convergence of legal and

administrative processes world-wide, each system will retain control over its own process of implementation. As an international financial centre with aspirations to become the leading financial centre in Asia and perhaps a global financial centre, Hong Kong must approach this process in a careful and calculated manner, albeit retaining its traditional elements of laissez-faire and capitalist enterprise.

B. Interaction with Public Financial Law in the PRC

Under the Joint Declaration and the Basic Law, China has determined that it will maintain Hong Kong's capitalistic system for a period of fifty years, thus creating an internal structure for the PRC of "one country, two systems".¹⁰⁶ While the ultimate goal of China's development is the creation of a "socialist market economy" under "Deng Xiaopeng Theory", achieved through the process of "crossing the river by feeling for the stones", HONG KONG will retain its present system until mid-way through the next century, if not longer.

Against this background, HONG KONG is likely to be a model for the development of public financial law on the Mainland. First, HONG KONG has developed its present system of financial law and regulation over time in reaction to the needs of its system for development and in reaction to significant internal and external crises.¹⁰⁷ Second, Hong Kong bridges the gap between an emerging market and a developed economy. As such, it possesses important experiences with the implementation of international financial standards that can be very instructive for China. Moreover, HONG KONG has played and, hopefully, will continue to play an important role in many of the processes that lead to the formulation of international consensus in the necessary requirements for financial stability, both domestic and international.¹⁰⁸ Third, HONG KONG has the human infrastructure and experience to be a teacher in a direct sense for Mainland regulators to gain experience with the workings of a developed financial system and the role of law and regulation therein.

For these reasons, public financial law on the Mainland is likely to increasingly resemble that of the SAR as time progresses. In fact, this is already occurring, with certain sections of the PRC's new Securities Law resembling the draft Securities and Futures Bill.

Notwithstanding the likely process of convergence of public financial law, increased cooperation between financial authorities on the Mainland and in the SAR will increase significantly – a process that has already begun in earnest

One example of a great success in this area has been the development of standards for the listing of Chinese companies in Hong Kong. In 1993, the Securities and Futures Commission, the Stock Exchange of Hong Kong (SEHK), the China Securities Regulatory Commission (CSRC), the Shanghai Securities Exchange and the Shenzhen Stock Exchange signed a Memorandum of Regulatory Cooperation¹⁰⁹. This agreement created the regulatory framework which enables Mainland enterprises to list in Hong Kong as H-shares.

Beyond cooperation, SAR regulators are already beginning to act as training agencies for Mainland agencies. For example, in 1995, an agreement concerning regulatory cooperation was signed between the SFC and the Chinese Securities Regulatory Commission (CSRC).¹¹⁰ As part of these cooperative relationships, the SFC, the Stock Exchange of Hong Kong (SEHK) and the Hong Kong Futures Exchange have a training programme for PRC regulators and exchange officials, as well as ongoing programmes for executives of H-share companies on the regulatory system, listing rules, take-overs and mergers rules, and investor relations.¹¹¹ Likewise, the HKMA and the People's Bank of China (PBC) have instituted mutual secondment programmes designed to increase understanding, cooperation and effectiveness within both systems.¹¹²

We would suggest that these are only the beginning of a long and close process of coordination, information sharing and collaboration.

VI. Implications for Legal Education at The University of Hong Kong

In terms of legal education, all this dictates a more coordinated study of banking and securities and other relevant areas of financial law: the broad umbrella is really one of “financial institutions”, “financial markets”, “financial institution and market law” – “public financial law”. In addition, such study will require a comparative law understanding of public financial law systems and of other countries and an international understanding of the Basle, IOSCO and other IFO processes will be

required. While much of the subject-matter will remain the realm of domestic law or “international soft-law”, the subject-matter as a whole should become an increasingly important dimension of “international economic law”

A most significant component of financial law in the 21st Century (whether in Asia, Africa, the Western Hemisphere or the Wider Europe) will involve, necessarily, an interdisciplinary and international conceptualisation of how regulatory and marketplace forces can interconnect compatibly to provide an appropriate legal environment for the eventual melding of a *new partnership* among the various financial institution regulators themselves and then among these combined and cooperating regulators, the financial institution industries, and the major international financial institutions¹¹³. In this context, traditional public lawyers need to come to terms with the increasing reality that “economic regulation” is becoming a significant part of “public law” simply, because it is *financial* regulation does not make it any less public law.

It is *not* proposed that the traditional relevance of private law aspects of financial law (*e.g.*, regarding the bank-customer relationship and financial instruments) will no longer be of importance. To the contrary, private financial and commercial law aspects should be of increasing educational and practical importance. What is suggested, however, is that the private law dimension will have to be evaluated in the overall context of an expanding, interconnecting, and converging (nationally, regionally, and internationally) regulatory framework for financial institutions and financial services.¹¹⁴

As such, the need to foster further and to maintain international supervisory/regulatory standards will be even greater. To this end, a greater educational, administrative and judicial understanding and appreciation of the increasing international regulatory dimensions of “financial law” will be required.

Also, one will need to study carefully the implications of how World Trade Organisation (WTO) liberalisation of financial services will accommodate legitimate prudential supervisory concerns. Defining this nexus between trade “liberalisation” and “safety and soundness” concerns for financial markets and institutions becomes a

major, cooperative challenge for trade/financial services officials and financial authorities, on the multilateral, regional and domestic levels¹¹⁵

Moreover, an integrated understanding of expanding regional approaches to financial sector development (e.g., with the European Union¹¹⁶ and NAFTA¹¹⁷) will be essential. This will have a heavy public international law dimension

In all events, the new economic and political dynamics shaping Hong Kong SAR are an increasingly globalised environment, the diversity of the underlying cultures and related values, the disparities in legal systems and approaches through the Greater China Area and East Asian Region, the sheer realities of the enormous changes that are occurring within East Asia, Latin America, Central and Eastern Europe and Southern Africa especially, the ongoing need for viable financial sector law reforms and the growing importance of international and regional cooperative efforts and of the role of international and regional financial and monetary institutions will all make significant legal impacts on the future scope for the teaching of “economic law”, and of “financial law”, in particular

Albeit, one could categorise a good portion of these developments as “soft law”, however, this does not diminish the legal significance and relevancy for setting new international “rules of the road” respecting financial markets and financial institutions (whether private, public or intergovernmental in nature) in the global environment of the 21st Century.¹¹⁸ Law (domestic or international) is not a static notion restricted by history and traditional notions. Law is indeed a dynamic and evolving concept. While shaped, in part, by history and while rooted in traditional law notions, law for our modern global society should be capable of embracing and “legally” responding to the dramatically changing nature and demands of our international economic, political and social environments. In this sense, the traditional legal dichotomies of public and private need to give way to a more fluid and relevant view of the dynamics of modern legal society

The new “financial law” for Hong Kong SAR in the 21st century will need to be steeped in a risk mesh of private law - commercial law, corporate law, effective private dispute resolution, etc (even enhanced accounting principles will have to be part of

the package. All this will need to be within a viable, responsive, yet constitutionally sound, public and administrative law framework, and will require a sound understanding of public and private international (conflicts of law and of the comparative law methodology¹¹⁹). Hong Kong's specialness as a separate legal system within the PRC should continue to draw from the well of English common law in a proactive and not a reactive manner. Hong Kong law should be neither English nor Chinese, but *sui generis* a mixture drawing on the best experiences from around the world.

"Global legal education" is in vogue. New York University Law School (NYU) claims to be "The Global Law School." NYU and the Oxford University are co-venturing a Global Law Programme under Professor Dan Prentice. Our own Centre for Commercial Law Studies at the University of London has propounded for over a decade its mission as a "global" one. These are but a few examples of the trend toward the "globalisation" of legal education.

As The University of Hong Kong Faculty of Law moves further toward the development of "centres of excellence", the "international" predominates. Human rights, international business and finance, international dispute resolution are all seen as essential ingredients of this excellence¹²⁰. Yet, still implicit in this search for excellence are the traditional dichotomies between public and private law and between public international law and international business/financial law. The reality, though, from a "global perspective" is a confluence and not a divergence among and within these traditional legal categorisations¹²¹.

Clearly Hong Kong SAR is a global environment, be it respecting trade, business, financial or cultural aspects. Such an environment merits a legal academy of international standards that can support, complement and promote such an environment. The HKU Faculty of Law is showing itself to be that academy.

But, what is a "global" law faculty? In a real sense, it is the combined and coordinated commitment of the University, the Faculty and community leaders to integrate the study of global legal issues within and throughout the law school environment and to create a vibrant forum for the ongoing discussion and critical

analyses of key global issues. In effect, global legal education will need to interconnect committed law faculty members with a core of top domestic and international law students and dynamic external elements of the local, Greater China, regional and international legal and business communities in order to create a synergistic environment for training and retooling lawyers, domestic and international, who will help build the global marketplace in East Asia in the 21st century.

The effectiveness of traditional legal institutions and paradigms increasingly is being challenged, eroded, and transformed by the development of more vigorous transnational, regional, and local institutions, by increasingly intertwined economic and financial markets, and by the exponential, innovative growth of information technology. This emerging “global environment” will necessitate the development of alternative legal and quasi-legal arrangements, standards, and institutions and fundamental constitutional, economic, and commercial law reform within and among the nation-states of the region and of the world. This will require lawyers capable of shaping and functioning within this new **“law-based” environment**, where traditional legal subject-matter categorisations are not controlling, and in many instances not relevant.¹²²

Global legal education is not primarily about conventional international and comparative law teaching or about producing lawyers to work in a select group of international law firms or intergovernmental institutions - although these aspects remain of considerable importance; but, it is about educating lawyers working in a local-domestic environment to understand and to be responsive to the sundry effects and implications of globalisation and about lawyers who can assist in affecting appropriate and meaningful policy, legal and institutional reforms conducive to sustaining and expanding a global environment. The new global environment significantly will impact most (but, not all) areas of traditional legal education (whether private or public) - commercial, business, financial, taxation, energy, environmental, intellectual property, information technology, litigation and alternative dispute resolution, healthcare, employment, telecommunications, criminal, administrative, constitutional etc.

Thus, the HKU Faculty of Law's goal should be to provide each of its students with the opportunity to prepare him/herself for the global environment of the 21st Century- whether the student will practice locally in Hong Kong, elsewhere in the region or overseas; will engage in a business, commercial, dispute resolution, or general practice; will be involved with governmental or intergovernmental institutions, or will be involved in the corporate or academic world

Our warmest congratulations to the Hong Kong Law Faculty on its Thirtieth Anniversary and sincerest best wishes for this Faculty's journey into the 21st Century and its pursuit of excellence in legal education and scholarship in an increasingly globalise environment.

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This chapter reflects the experiences of the authors in speaking, consulting and advising in all aspects of financial law world-wide, including in Hong Kong, Beijing, Bangkok, Seoul, London, Southern Africa, South America, Central and Eastern Europe and the former Soviet Union, the United Kingdom and the United States.

¹ "Public financial law" is the law of regulation and supervision of financial institutions and markets. Traditionally, "financial law" has been dominated by private law, especially contract. However, during the past two decades, a distinct area of public financial law has developed as a reaction to the potential dangers of unregulated and underregulated financial institutions and markets. For a discussion of the develop of public financial law relating to banking, see J Norton, *Developing International Bank Supervisory Standards* (Dordrecht: Kluwer Academic 1995).

² See generally U.S. Department of the Treasury, *op. cit.*, n 10 at 261-298; I. Topley, *Hong Kong Banking Law and Practice* (1996); R. Ho, R. Scott & K. Wong (eds.), *The Hong Kong Financial System* 381 (Hong Kong: OUP 1991); T. Ghose, *The Banking System of Hong Kong* (1987).

³ See B FC Hsu, *Laws of Banking and Finance in the Hong Kong SAR* (Hong Kong: Open University of Hong Kong 1998), pp. 152-70, 235-43.

⁴ *Ibid.* at 152-70.

⁵ *Ibid.* at 235-43.

⁶ *Cf.* RC Smith and I Walter, *Global Banking* (Oxford: OUP 1997).

⁷See Remarks by Janet L. Yellen, Board of Governors of the Federal Reserve System, at the Conference on Recent Developments in the Financial System, Jerome Levy Economic Institute of Bard College (Apr. 11, 1996), available in the Lexis Banking Library.

⁸See JJ Norton (ed.) *Prospects for Int'l Lending and Reschedulings* (New York: Matthew Bender 1988); CT Ebenroth, 'Innovations in LDC Debt Conversions', Ch. 3 in JJ Norton & R. Auerback (eds.), *International Finance in the 1990s: Challenges and Opportunities* (Oxford: Blackwell 1993).

⁹See Basle Committee on Banking Supervision, 'International Convergence of Capital Measurement and Capital Standards' (July 1988) (the "Capital Accord").

¹⁰See IMF Background Paper I, Capital Adequacy and Internal Risk Management, in *International Capital Markets: Developments, Prospects, and Policy Developments* (Aug. 1995), at 136-37 n.2. See also JJ Norton, *Devising International Bank Supervisory Standards* (Kluwer Academic Publ., 1995), at 190-200 (explaining in detail the 1988 Capital Accord). See also note 21, *infra*.

¹¹See, e.g., A. Crockett, 'The Future of Banking Regulation', *Euromoney*, Sept. 1995, at 272-73.

¹²Cf. JH Jackson, 'Regulatory International Economic Behaviors - Reflection on the Broader Settings of International Financial Markets and Institutions', Ch. 1 in JJ Norton and M. Andenas, *Emerging Financial Markets and the Role of International Financial Organisations* (London: Kluwer Law Int'l 1996).

¹³See Basle Committee on Banking Supervision, 'Basle Capital Accord: Treatment of Potential Exposure for Off-Balance Sheet Items' (Apr. 1995) (hereinafter "Capital Accord Amendment").

¹⁴Cf. G. Soros, *The Crises of Global Capitalism* (New York: Public Affairs 1998).

¹⁵For the development of a similar system in the U.K. prior to 1979, see C. Hadjiemmanuil, *Banking Regulation and the Bank of England* (London: LLP 1996).

¹⁶Y.C. Jao, *Hong Kong as an International Financial Centre: Evolution, Prospects and Policies* (Hong Kong: City University of Hong Kong 1997), p. 26.

¹⁷Chap. 155, Laws of Hong Kong.

¹⁸The Banking Act 1979 itself was largely a response to the need to implement "best practices" in the area of banking regulation and supervision as adopted by the European Community. See Norton, *op. cit.*, n. 1, pp. 69-91.

¹⁹Basle Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards* (July 1988) (the Basle Accord of 1988). The Basle Accord has been periodically amended, most recently in September 1997. Basle Committee on Banking Supervision, *Amendment to the Capital Accord to Incorporate Market Risks* (Jan. 1996, mod'd in Sept. 1997).

²⁰See I. Tokley, *op. cit.*, n. 2.

²¹*Topical Information: Banking in Hong Kong* (1997), available at <http://www.info.gov.hk/info/banking.htm>.

²²Chap. 148, Laws of Hong Kong.

²³See HKMA, *Annual Report 1996*; I. Tokley, *op. cit.*, n. 2.

²⁴*Id.*

²⁵*Id.*

²⁶Chap. 66, Laws of Hong Kong.

²⁷Chap. 155, Laws of Hong Kong.

²⁸S. 7(1), Banking Ordinance.

²⁹See Hong Kong Monetary Authority, Policy Objectives of the Hong Kong Monetary Authority, available at <http://www.info.gov.hk/hkma>.

³⁰s. 7(3), Banking Ordinance.

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- ³¹ See HKMA, *Approach to Supervision* (30 April 1997).
- ³² HKMA, *Annual Report 1996*.
- ³³ Basle Committee on Banking Supervision, *Amendment to the Capital Accord to Incorporate Market Risks* (Jan. 1996).
- ³⁴ HKMA, *Annual Report 1996*.
- ³⁵ The Basle Concordat was originally agreed in 1983, following the collapse of Banco Ambrosiano. Basle Committee on Banking Supervision, *Principles for the Supervision of Banks' Foreign Establishments* (May 1983). It was supplemented in 1990. Basle Committee on Banking Supervision, *Information Flows between Banking Supervisory Authorities* (Supplement to the "Basle Concordat" of May 1983) (Apr. 1990). See Norton, *op. cit.*, n 1.
- ³⁶ Basle Committee on Banking Supervision, *Minimum Standards for the Supervision of International Banking Groups and their Cross-border Establishments* (July 1992).
- ³⁷ HKMA, *Annual Report 1996* at 91.
- ³⁸ *Id.* at 92-93.
- ³⁹ *Id.* at 91.
- ⁴⁰ *Id.* at 92.
- ⁴¹ Bank of China, *Annual Report 1996*.
- ⁴² I. Tokley, *op. cit.*, n 2.
- ⁴³ HKMA, *Annual Report 1996* at 6.
- ⁴⁴ E.g., Securities Ordinance, Chap. 333, Laws of Hong Kong (1974); Protection of Investors Ordinance, Chap. 335, Laws of Hong Kong (1974); Stock Exchange Unification Ordinance, Chap. 361, Laws of Hong Kong (1980).
- ⁴⁵ See Securities Review Committee, *Report of the Securities Review Committee* (May 1988).
- ⁴⁶ *Ibid.*; see Hsu, *op. cit.*, n 2 at 240.
- ⁴⁷ See K. Wong, "The Hong Kong Stock Market", in R. Ho, R. Scott & K. Wong, *op. cit.*, n 2 at 215.
- ⁴⁸ For development of this hypothesis, see J. Seligman, *The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance* (1982).
- ⁴⁹ Chap. 24, Laws of Hong Kong.
- ⁵⁰ Chap. 32, Laws of Hong Kong.
- ⁵¹ Chap. 82, Laws of Hong Kong.
- ⁵² Chap. 396, Laws of Hong Kong.
- ⁵³ Chap. 351, Laws of Hong Kong.
- ⁵⁴ Chap. 395, Laws of Hong Kong.
- ⁵⁵ Chap. 396, Laws of Hong Kong.
- ⁵⁶ SFC, Consultation Paper on a Draft for a Composite Securities and Futures Bill (April 1996) (available at <http://www.hksfc.org.hk>).
- ⁵⁷ For information on IOSCO, see their website at <http://www.iosco.org>.
- ⁵⁸ HKSFC, *Annual Report 96/97: A Strategic Outlook for the Future* (1997).
- ⁵⁹ *Ibid.*
- ⁶⁰ See D Arner, 'The Mexican Peso Crisis of 1994-95: Implications for the Regulation of Financial Markets' [1996] 2 NAFTA Review 28 (Fall 1996), p. 4.

⁶¹ Group of Ten (G-10), "A Strategy for the Formulation, Adoption and Implementation of Sound Principles and Practices to Strengthen Financial Systems", *Report of the Group of Ten (G-10) Working Party on Financial Stability in Emerging Markets, Financial Stability in Emerging Market Economies* (Basle: April 1997). G-10 documents are available at the Bank for International Settlements (BIS) website at <http://www.bis.org>.

⁶²Basle Committee on Banking Supervision, *Core Principles for Effective Banking Supervision* (Sept. 1997).

⁶³*Cf.* D Arner, 'An Analyses of International Support Packages in the Mexican and Asian Financial Crises' [1998] *Journal of Business Law* 380-396 (July 1998); and JJ Norton, 'The Thai Financial Crises Delving Behind the Facade of Financial Sector Reform and the Need for an Interdisciplinary Approach' [1998] 28 *Thammasat Law Journal* No. 2 246-276.

⁶⁴*Cf.* D Arner, *op. cit.*, n 60.

⁶⁵*See, inter alia*, JJ Norton & D Arner, 'International Co-Operative Efforts and Implications for Law Reform' Ch. 9 in R Lastra and HN Shiffman (eds.), *Bank Failures and Bank Insolvency Law in Economies in Transition* (London: Kluwer Law Int'l 1999).

⁶⁶*See* R Lastra, 'Developments in International Banking Regulatory Cooperation' [1997] *Yearbook of International Financial and Economic Law-1996*, 405-418 (London: Kluwer Law Int'l 1998).

⁶⁷*See* Joint Forum and Financial Conglomerates, *Supervision of Financial Conglomerates* (February 1999); and *see generally*, GA Walker, 'The Law of Financial Conglomerates: The Next Generation' [1996] 30 *International Lawyer* 57.

⁶⁸IOSCO, established in 1983, has roughly over 120 voting, affiliate, and associate members, who are primarily securities regulators, self-regulatory organisations, and related international organisations. The IOSCO Technical Committee, composed of developed country members, and development committees, composed of members from countries with emerging markets, are the two principal committees through which policies or recommendations are proposed.

⁶⁹IOSCO resolutions are available at the IOSCO website at <http://www.iosco.org>.

⁷⁰For a list of IOSCO MoUs, see the IOSCO website at <http://www.iosco.org>. *See also*, Hendrick Jordaan, 'IOSCO's Contributions to MoUs with Emerging Market Countries: an Analysis in Light of SEC Experiences' [1999] 2 *Yearbook of International Financial & Economic Law-1997*.

⁷¹*See* Joint Forum, *op. cit.*, n 67.

⁷²*See* Report of the Group of Ten (G-10) Working Party on Financial Stability in Emerging Markets, *Financial Stability in Emerging Market Economies: A Strategy for the Formulation, Adoption and implementation of Sound Principles and Practices to Strengthen Financial Systems* (April 1997) (available at <http://www.bis.org>), p. 49.

⁷³Basle Committee on Banking Supervision, *Core Principles of Effective Banking Supervision* (Basle: Sept. 1997). Basle Committee documents are available at the BIS website at <http://www.bis.org>.

⁷⁴Basle Committee on Banking Supervision, *Compendium of Documents Produced by the Basle Committee on Banking Supervision* (Basle: 1997 updated).

⁷⁵Jao, *op. cit.*, n 16 at 94.

⁷⁶HKMA, *Core Principles for Effective Banking Supervision: An Assessment of the Position in Hong Kong* (1 Dec. 1997).

⁷⁷*See* Hsu, *op. cit.*, n 3 at 229-32.

⁷⁸IOSCO, *Objectives and Principles of Securities Regulation* (Sept. 1998). IOSCO documents are available at the IOSCO website at <http://www.iosco.org>.

⁷⁹IOSCO, *International Disclosure Standards for Cross-border Offerings and Initial Listings by Foreign Issuers* (May 1998).

⁸⁰*See* IOSCO, *Annual Report 1996*. *See also* the website of the IASC at <http://www.iasc.org.uk>.

⁸¹See, e.g., JJ Norton, 'Towards an International Financial Centre for Greater China: Hong Kong and Infrastructure Reform' [1998] 28 Hong Kong Law Journal, Part 2, 209-229.

⁸²Cf. JJ Norton, 'Structuring the Banking Regulators and Supervisors: Developed Country Experiences and their Possible Implications for Latin America and the Developing Countries' [1998] 4 NAFTA Law & Business Review of the Americas, No. 3, 5-29.

⁸³For further information, see the IOSCO website at <http://www.iosoc.org>.

⁸⁴It is hoped that in the near future further information will be available at the Bank of International Settlements website at <http://www.bis.org>, where IASC is now physically located.

⁸⁵Further information is available from the IASC website at <http://www.iasc.org>.

⁸⁶The three Associations of bank, securities and insurance supervisors collaborate through a "Joint Forum" with respect to issues arising from the rise of international conglomerate financial institutions

⁸⁷E.g., on recent U.S. experiences, see *infra alia* JJ Norton, 'The Glass-Steagall Act and Related Bank Legislative Reform in the United States' [1998] 14 B.F.L.R. 1-42.

⁸⁸For a more detailed analysis of the failure of Barings plc and its ramifications on international regulatory convergence, see JJ Norton & CD Olive, 'The Globalisation of Financial risks and International Supervision of banks and Securities Firms: Lessons From the Barings Debacle' [1996] 30 International Lawyer 305-23.

⁸⁹See JJ Norton, 'The Mexican Peso Crisis and the Future of Financial Integration in the Americas,' Ch. 12 in JJ Norton, M Andenas & M Footer, *The Changing World of International Law in the Twenty-First Century: A Tribute to the Late Kenneth R. Simmonds* (London: Kluwer Law Int'l 1998).

⁹⁰See, *inter alia*, P Power, 'Sovereign Debt: The Rise of the Secondary Market and its Implications' [1996] 64 Fordham Law Review. 2701.

⁹¹See Bank for International Settlements, Committee on Payment and Settlement Systems (CPSS), *Settlement Risk in Foreign Exchange Transactions* (Mar. 1996).

⁹²Cf., generally, J Norton & J Olsen (eds.), *Banks: Fraud and Crime* (London: Lloyds of London Press, 2d. ed. 1999 forthcoming; 1st ed. 1995).

⁹³See generally, Group of Twenty-two Systemically Significant Countries, Reports on the International Financial Architecture (Oct. 1998).

⁹⁴See JJ Norton & C Reed (eds) *Cross-Border Electronic Banking* (London: Lloyds of London Press, 1994).

⁹⁵JK Winn, 'The Impact of the Internet on U.S. Regulation of Securities Markets' [1999] 2 *Yearbook of International Finance & Economic Law*.

⁹⁶See e.g., JH Jackson, *The World Trade Organization Constitution and Jurisprudence* (1998).

⁹⁷See, *inter alia*, JJ Norton & D Arner, 'International Co-Operative Efforts and Implications for Law Reform,' Ch. 9 in R. Lastra and H. N., Schiffman (eds.), *Bank Failures and Bank Insolvency Law in Economies in Transition* (London: Kluwer Law Int'l 1999).

⁹⁸See, *inter alia*, Norton, *infra* note 23.

⁹⁹See JJ Norton, 'Financial Sector Reform and International Financial Crises: The Legal Challenges' in *International Financial and Economic Law*, No. 16 (London Institute of International Banking, Finance and Development Law 1998).

¹⁰⁰ See generally R Cranston, *Principles of Banking Law* (Oxford Univ. Press, 1998).

¹⁰¹ JJ Norton, 'The Korean Financial Crises Reform and Positive Transformation: Is a Second "Han River Miracle" Possible?' [1998] 27 *Global Economic Review* No. 2, 3-36.

¹⁰² See e.g., S Fischer (IMF Deputy Managing Director) 'Reforming World Finance, Lessons from a Crises,' *The Economist* (October 3-9, 1998).

¹⁰³ Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China (adopted at the 3d Session of the Seventh National People's Congress, 4 April 1990) (Basic Law), Art. 109: "The Government of the Hong Kong Special Administrative Region shall provide an appropriate economic and legal environment for the maintenance of the status of Hong Kong as an international financial centre."

¹⁰⁴ Financial Secretary's Office, *Hong Kong: Centre for International Business* (1997) (available at <http://www.info.gov.hk/fb/bdgt97/leaflet/ebusin.htm>).

¹⁰⁵ For an analysis of Hong Kong's strengths and weaknesses as an international financial centre, see R Yan-Ki Ho, "Hong Kong as an International Financial Centre", in R. Ho, R. Scott & K. Wong, *op. cit.*, n 2.

¹⁰⁶ Basic Law, Preamble ("one country, two systems"), Art. 5 ("The socialist system and policies shall not be practised in the Hong Kong Special Administrative Region, and the previous capitalist system and way of life shall remain unchanged for 50 years.").

¹⁰⁷ See generally, R. Ho, R. Scott & K. Wong, *op. cit.*, n 2. See also, I. Topley, *op. cit.*, n 2; T. Ghose, *op. cit.*, n 2.

¹⁰⁸ Anthony Neoh, former Chairman of the HKSFC, also served as Chairman of the Technical Committee of IOSCO. In that position, he played a leading role in the development of IOSCO's minimum standards and core principles for securities regulation, drafted at the behest of the Group of Seven (G-7) following the events of the Mexican Peso Crisis. See IOSCO, *Annual Report 1996*.

¹⁰⁹ HKSFC, *Confidence in the Markets* (June 1997).

¹¹⁰ *Id.*

¹¹¹ *Id.*

¹¹² HKMA, *Annual Report 1996*, *op. cit.*

¹¹³ JJ Norton and CD Olive, 'The Ongoing Process of International Bank Regulatory and Supervisory Convergence: A New Regulatory Market "Partnership"' [1997] 16 *American Review of Banking Law* 227-309.

¹¹⁴ Cf. JJ Norton, 'International Banking Law on the Threshold of the 21st Century', *Essays in International Financial & Economic Law*, No. 1 (London Institute of International Banking Finance and Development Law 1996).

¹¹⁵ Cf. JH Jackson, 'Regulating International Economic Behaviors - Reflections on the Broader Settings of International Financial Markets and Institutions,' Ch. 1 in JJ Norton and M Andenas, *Emerging Markets and the Role of International Financial Organisations* (London: Kluwer Law Int'l 1996); and ME Footer, 'GATT and Foreign Banking as a Trade in Services' Ch. 2 in JJ Norton et al. (eds.), *International Banking Operations and Practices: Current Developments* (Dordrecht: Martinus Nijhoff 1994).

¹¹⁶ See, *inter alia*, Michel Gruson, 'Convergence of Bank Prudential Supervision Standards and Practices Within the European Union,' essays in *International Financial & Economic Law*, No. 20 (London Institute of International Banking, Finance and Development Law, 1999).

¹¹⁷See J Bello, A Holmer & JJ Norton, *NAFTA: A New Frontier in International Trade and Investment in the Americas* (Washington DC: American Bar Ass. Press, 1994).

¹¹⁸On notion of “international soft law,” see, *inter alia*, Norton, op. cit., n 1, chs. 5 and 6.

¹¹⁹See generally JJ Norton, *Reflections on the Future of Banking Law in the New Hong Kong SAR*, introduction to a 25th Anniversary Symposium for the University of Hong Kong Law Faculty as updated in [1998] 1 *Yearbook of International Financial & Economic Law*-1996, 183-202 (London: Kluwer Law Int'l).

¹²⁰*E.g.*, the UHK Law Faculty has recently introduced comprehensive and innovative postgraduate programmes in “Corporate and Financial Law” and in “Human Rights.”

¹²¹The UHK Law Faculty is presently embarking upon establishing an Asian Institute of International Financial Law as an interdisciplinary institute for postgraduate research and studies that endeavours to embrace this “global perspective.”

¹²²*E.g.*, on 4-5 June 1999, the UHK Law Faculty and its new Asian Institute will conduct a high-level, international conference on the “Challenges for the New International Financial Architecture” Lessons for East Asia. This will be the centrepiece of a series of related “global” conferences held in London, the U.S., Thailand, South Africa, Cologne, and Montevideo.

AIIFL

DRAFT PROSPECTUS

**ASIAN INSTITUTE OF INTERNATIONAL
FINANCIAL LAW⁺⁺**

**At the Faculty of Law
THE UNIVERSITY OF HONG KONG**

⁺⁺ Approved by the Board of Faculty of Law on 14 May 1999.

Asian Institute of International Financial Law

Background Information

Creation

The Asian Institute of International Finance Law was established in 1999 with the support and encouragement of Vice Chancellor Y.C. Cheng of the University of Hong Kong and Dean Albert Chen of the HKU Faculty of Law. The Institute, based at the HKU Faculty of Law, is to be a cooperative University and Hong Kong community venture (supported in part through University funds, Faculty funds, and private and public contributions and grants) and is designed to involve the interdisciplinary talents of interested, expert members of the Faculty of Law, the School of Business, the School of Economics and Finance, the Department of Real Estate and Construction and of other internal and external interested, expert parties.

*Advisory Boards**

The Institute will seek and rely upon the advice, guidance and support of a distinguished Academic Advisory Board and a distinguished Professional Advisory Board.

Academic Advisory Board:

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- Professor Peter Ellinger, Professor Emeritus of Banking and Commercial Law, National University of Singapore
- Professor Gao Shangquan, Chinese Banking Research Institute, Hainan, PRC and Ph.D. Adviser, Peking University
- Professor Benjamin Geva, Professor of Law and Editor, Banking and Financial Law Review, Osgoode Hall Law School, York University, Toronto
- Professor Mario Giovanoli, Legal Advisor, Bank for International Settlements and Professor of Banking Law, University of Lausanne
- Professor Roy Goode, Professor Emeritus, Oxford University
- Professor Norbert Horn, Professor and Director, Banking Law Institute, University of Cologne
- Professor Y.C. Jao, Professor of Economics, School of Economics and Finance, HKU
- Professor Hideki Kanda, Professor of Law, The University of Tokyo
- Dr. Andreas Kellerhals, Director, Postgraduate Programme in International Business Law, Zurich University
- Professor Jan Kleineman, Faculty of Law, Stockholm University.
- Professor Justice Francois Malan, Justice, Supreme Court of South Africa and Co-Director, RAU Banking Law Institute, Johannesburg
- Professor Geoffrey Miller, Director, Center for the Study of Central Banking, New York University School of Law
- Professor Yung Chul Park, Professor of Economics, Korea University, Seoul
- Professor Dan Prentice, Allen & Overy Professor of Corporate Law and Director, Institute for the Study of Global Law, Oxford University
- Professor Ian Ramsay, Professor and Director, Centre for Corporate Law and Securities Regulation, The University of Melbourne
- Professor Hal Scott, Nomura Professor of International Financial Systems, Harvard Law School
- Ms. Judith Sihombing, Senior Lecturer, Faculty of Law, HKU
- Professor Marc I Steinberg, President, SMU Institute of International Finance and Senior Associate Dean and Rupert and Lillian Radford Professor of Law, SMU School of Law, Dallas
- Professor Richard Y.C. Wong, Director, School of Business, HKU
- Professor Philip Wood, Senior International Banking Partner, Allen & Overy, London, and Visiting Professor, Centre for Commercial Law Studies, University of London
- Professor Wu Ziphon, Dean and Professor of Banking Law, Peking University

* All individuals hereinafter are to be formally appointed in accordance with the Constitution.

Professional Advisory Board

Mr. Stefan Gannon, JP, General Counsel, HKMA
Mr. Y. Huang, Head, Legal Department, Bank of China, Beijing
Mr. Donald Koo, Koo & Partners, Hong Kong
Mr. Larry Kwok, Senior Partner, Kwok & Yih, Hong Kong
Mr. Barry Metzger, Partner, Coudert Brothers, New York and former General Counsel, Asian Development Bank
Mr. Kenneth Ng, Head, Legal & Compliance, HSBC
Mr. Andrew Procter, Executive Director, Intermediaries and Investment Products Division, HKSFC
Mr. John T. Shingle, General Counsel, Solomon Brothers Inc., New York
Mr. Benjamin Vandegrift, Partner, Pillsbury Madison & Sutro, Washington, D.C.
Mr. Kirk Vanikuil, Legal Advisor, Bank of Thailand
Dr Bill C P Kwok, Chairman, Hong Kong Securities Institute

See p.10 for a summary of the Institute's organisational structure.

General Objectives and Strategy

The general objective of the Institute is to assist the Faculty of Law in developing, within the University and in conjunction with its own Faculty Groups on Corporate and Financial Law, Chinese Law and Public and Comparative Law and with other interested Schools and Departments of the University and without the University, and with the local business and financial communities, a "partnership" for establishing a leading Asian academic centre in the area of international financial law, with emphasis on the development of high-quality courses, teaching and research. To accomplish this objective, the Institute seeks: (i) to promote scholarly research, teaching, and writing in the area of international finance and law; (ii) to develop a programme of scholarship for graduate students interested in international finance, in particular through the LLM (Corporate and Financial Law) and SJD degrees at HKU (these degree programmes will form the internal "core" of the Institute's activities); (iii) to serve as a permanent and multidisciplinary institute in the international finance area (e.g., through the presentation of annual symposia, executive courses, and other relevant programmes, and through high quality interdisciplinary publications); (iv) to develop student centred teaching/research vehicles for use locally, regionally and internationally (including a developed interactive distance learning programme for executives and post-graduate students); and (v) to provide a common meeting ground and forum for executives, financiers, lawyers, accountants, economists, civil servants, and academics involved in international financial affairs. More specific objectives of the Institute will be determined, from time to time, by its Board of Directors upon consultation with the Institute's Advisory Boards, the Dean of the Faculty of Law, and the Heads of the Department of Law and Department of Professional Legal Education, HKU.

The Institute's Activation in Hong Kong and Launch Conference

With the recent East Asian financial crisis and world-wide "contagion" implications, there has come about a renewed local interest of the Hong Kong financial, business and governmental sectors in international business/finance, particularly as to the law-based dimensions. Accordingly, it is only fitting for the Faculty of Law at The University of Hong Kong to establish in Hong Kong, one of the leading Asian financial centres, an Asian-based and interdisciplinary Institute to focus on regional/international banking and finance issues of importance to the local community, to the region and to the world. In creating the Institute, a close partnership with the Hong Kong and Asian business/financial communities is intended.

To launch its formation and that of Faculty's new LLM (Corporate and Financial Law), the Institute will sponsor or co-sponsor, over calendar year 1999, major international conferences in Hong Kong, Europe, the United States, Southern Africa, South America and Thailand. The primary launch conference will be on 4-5 June 1999 in Hong Kong, and will involve over 30 experts addressing the issues associated with the "new international financial architecture".

The Institute's Global Network

More generally, the Institute will seek close, substantive, and collaborative relationships with leading academic institutes in the international banking and finance area throughout Asia and on a world-wide basis. This collaboration will entail faculty and student exchanges, joint research and publication efforts and development of new student-centred learning vehicles (including computer aided interactive learning and video conferencing in a number of courses), and regular co-sponsorship of high-level international conferences/research seminars.

Asia

Financial Law Institute, Peking University
Korea Institute of Finance, Seoul
Thammasat University Faculty of Law, Bangkok
Chinese Banking Research Institute, Hainan, PRC

UK

Centre for Commercial Law Studies, University of London
London Institute of International Banking, Finance and Development Law
Institute of European Finance

Continental Europe

Banking Law Institute, University of Cologne
University of Zurich, Postgraduate Programme in International Business Law
Institute for Banking Law, University of Bern
Faculty of Law, Stockholm University

North America

Center for the Study of Central Banking, New York University
SMU Institute of International Banking and Finance, Dallas, Texas

South America

University of Buenos Aires, Graduate Banking Law Programme

Africa

RAU Banking Law Institute, Johannesburg, South Africa
Faculty of Law, Witswatersrand University, Johannesburg

Australasia

Centre for Corporate Law and Securities Regulation, University of Melbourne

The Institute's Publication Vehicles

The Institute will be jointly responsible for major publications such as the *Yearbook of Asian Commercial and Financial Law* and the *Yearbook of International Financial and Economic Law* and a major book series in *International Banking and Financial Law*. The *Yearbook of Asian Commercial and Financial Law*, which will be jointly published with the London Institute of International Banking, Finance and Development Law and the SMU Institute of International Banking and Financial Law, will be the Institute's "flagship" publication. Further, the Institute will join London (and the Centre for Commercial Law Studies) and SMU in developing a major Essay Series on "Studies in International Financial and Economic Law". Moreover, from time to time, the Institute will endeavour to present high quality articles and symposia in the *Hong Kong Law Journal*, in other leading Asian and international journals and in book series with leading academic publishers.

The Technology Component

In stages, over time and subject to necessary funding resources, the Institute is committed to developing an internet website that will make available all Institute-related publications, LLM course materials, and key conference materials. It is envisioned that this website can be a base for developing interactive distance learning programmes for LLM and executive/professional courses on a local, regional and international basis.

The Interdisciplinary Component

The Institute will conduct its activities on an interdisciplinary basis emphasising the legal, business/finance, economic, socio-political and accounting dimensions of the subject matter.

Institute's Current and Future Plans

The Institute's current and future plans, subject to requisite budgetary and staffing support, envision the following activities on an annual basis:

1. Support of a quality LLM degree programme in Corporate and Financial Law. The goal is to make this programme the leading one of its kind in East Asia and one of the leading ones in the world. Emphasis will be on developing, over time and in stages, effective student-centred learning vehicles for the various courses that can be used locally, regionally and internationally.
2. Support of the quality development of the new post-graduate SJD (Doctor of Juridical Science) degree. The goal of the Institute is, in time, to take on and to supervise 2-4 highly qualified doctoral students annually.
3. Conduct of a major annual international conference at HKU -- beginning with the 4-5 June 1999 "launch conference" on the "new international financial architecture". Each conference will attract international experts and will be designed to lead to one or more substantive publications and to curricular and faculty research enhancement.
4. Conduct of one or two high-level research seminars, beginning this year in Autumn 1999, on matters of current interest and concern. The Autumn 1999 seminar will concern the impact of globalisation on the teaching of commercial and financial law courses. Leading experts, drawn world-wide, will present their views and suggestions on how the HKU can enrich and better its current range of commercial and financial courses.
5. Organisation of a semi-annual Distinguished Lecture Series, bringing to Hong Kong leading world experts. One such lecture will emphasise international and comparative commercial law aspects. The other will concern financial sector reform issues. It is hoped that the Hong Kong Law Journal will publish these lectures.
6. Running of a series of two high-quality "Executive Short Courses" in September and two others in January of each year, and of quality professional programmes in June and December of each year.
7. Promotion of scholarly publications in the area of international financial law through active involvement in and co-sponsorship of a major international book series, Yearbook and Essay Series.
8. Promotion and support of cutting-edge research projects, course development, and technological learning enhancement in the area of international financial law.

*Institute's Leadership and Faculty**

A team of international experts, drawn from the HKU Faculty of Law, other HKU Faculties and Schools, and externally, comprise the Institute's Leadership and Faculty in connection with its development and conduct of courses, conferences, research seminars and roundtables, lecture series, journal and book series, and postgraduate academic projects and research.

* All individuals hereinafter mentioned are to be formally appointed or invited in accordance with the Constitution.

Institute's Advisory Board: See above

Institute's President: Mr. Anthony Neoh, QC, SC

Institute's Co-Executive Directors: Professor Joseph J. Norton
Mr. Say Goo

Institute's Deputy Directors: Ms. Lusina Ho (Equity in Commercial Law)
Ms. Katherine Lynch (Corporate Law/Dispute Resolution)
Mr. Philip Smart (Corporate Law/Insolvency)
Mr. Richard Wu (HK Financial Law)
Mr. Zhang Xian Chu (PRC Financial Law)

Participating Professorial Fellows

The Institute's participating professorial fellows comprise (1) members of the HKU Financial Law Group, (2) HKU Consulting Law Members, (3) HKU Interdisciplinary Members, and (4) distinguished external professors and fellows.

A. The HKU Faculty of Law Financial Law Group

In this context, the following full-time and adjunct members of the HKU Faculty of Law have come together to form a Financial Law Group component of the Institute's Faculty. These members of the Faculty of Law are as follows (in alphabetical order):

- Mr. Charles Booth, BA (Yale), JD (Harvard). Associate Professor and Associate Dean and Member, Institute Academic Advisory Board. Expertise/Interest: Insolvency Generally and Comparative and Cross-Border Insolvency
- Ms. Anne Carver, BA, MA (Cantab.). Associate Professor. Expertise/Interest: HK Business/Commercial Law
- Mr. Say Goo, LLB (Leicester), LLM (East Anglia). Associate Professor. Expertise/Interest: Corporate Governance & Shareholder Remedies, Financial Law
- Mr. Andrew Halkyard, LLB (ANU), LLM (Virginia). Associate Professor. Expertise/Interest: International Taxation
- Ms. Betty Ho, MA (Berkeley), LLB (Toronto). Associate Professor. Expertise/Interest: HK and Chinese Commercial Law
- Ms. Lusina Ho, BA, BCL (Oxon). Associate Professor. Expertise/Interest: Commercial Law and Restitution
- Mr. Michael Jackson, LLB (Auckland), LLM (BC). Assistant Professor. Expertise/Interest: Business Crime
- Ms. Alice Lee, LLB (HKU), BCL (Oxon). Assistant Professor. Expertise/Interest: Credit and Security
- Mr. Yahong Li, LLB (Suffolk), LLM (Beijing), JD (Suffolk). Research Fellow. Expertise/Interest: Chinese and HK Law
- Mr. Nanping Liu, LLB (Wuhan), LLM, SJD (Yale). Assistant Professor. Expertise/Interest: Chinese Economic Law
- Ms. Katherine Lynch, BA, LLB (Osgoode), LLM (Cantab.), MJS (Stanford). Associate Professor. Expertise/Interest: Financial Law, Dispute Resolution
- Mr. J.A. McInnis, LLB (Sask), BCL, LLM (McGill), FCI Arb. Associate Professor. Expertise/Interest: Project Finance
- Mr Robert Morgan, BA (Hons), LLM, FCI Arb, FSI Arb, AMAE, FRSA, Barrister (England & Wales), Research Assistant Professor. Expertise/Interest: Dispute Resolution
- Professor Joseph J. Norton, LLB (Edin), LLM (Texas), SJD (Mich.), DPhil (Oxon). Vice-Chancellor's Distinguished Visiting Professor of Law. Expertise/Interest: Financial Law
- Ms. Judith Sihombing, LLB (Melb), LLM (Malaysia). Senior Lecturer and Member, Institute Academic Advisory Board. Expertise/Interest: Banking and Commercial Law
- Mr. Philip Smart, LLB (London). Associate Professor. Expertise/Interest: Insolvency Generally and Comparative and Cross-Border Insolvency
- Ms. Anna Tam, LLB (HKU), LLM (Yale). Assistant Professor. Expertise/Interest: Banking Law
- Ms. Carol Tan, LLB, LLM (London). Research Fellow. Expertise/Interest: Foreign Direct Investment in South East Asia.

- Mr. Richard Wu, LLB (HKU), BSC, LLM (London), MBA (Warwick). Assistant Professor. Expertise/Interest: Financial Law
- Mr. Guanghua Yu, BA (Shanghai Maritime), LLM (Osgoode), LLB, SJD (Toronto). Assistant Professor. Expertise/Interest: PRC and HK Financial Law
- Mr. Xian Chu Zhang, LLB (U of Poli Sc & Law, Beijing), MCL, JD (Indiana). Assistant Professor. Expertise/Interest: Chinese Corporate and Financial Law

B. *HKU Consulting Law Members*

In addition to financial subject-matter, appropriate and effective financial reform requires a consideration of the underlying constitutional/judicial/public law order and of comparative law considerations. In this respect, the HKU Faculty of Law is especially benefited by the presence of distinguished Comparative and Public Law and Chinese Law Groups. Members of these Groups, who are involved as Professorial Fellows of the Institute, include:

Professor Johannes Chan, LLB (HKU), LLM (London). Expertise/Interest: International Human Rights and Constitutional Law

Ms. Jill Cottrell, LLB, LLM (London), LLM (Yale). Senior Lecturer. Expertise/Interest: Environmental Law

Dr. Peter Feng, BA (Kunming), MA (Beijing), PhD (Harvard), JD (Harvard). Associate Professor. Expertise/Interest: Chinese Law and International Intellectual Property Law

Mr. Donald Lewis, AB (USC), JD (Emory), LLM (London). Associate Professor. Expertise/Interest: Chinese Commercial Law and International Business Law

Professor Roda Mushkat, LLB (Jerusalem), LLM (Wellington), LLD (South Africa), Postgrad Dip Int'l (Manchester). Expertise/Interest: International Law.

C. *HKU Interdisciplinary Members*

The Institute's Faculty is further complemented by the active involvement of other HKU faculty members, including the following:

Professor Eric C. Chang, Professor of Finance and Director, Centre for Financial Innovation and Risk Management, School of Business, HKU

Dr. Berry Hsu, Associate Professor of Law, Department of Real Estate and Construction, HKU.

Professor Y C Jao, Professor of Economics, School of Economics and Finance, HKU.

D. *External Professorial Fellows*

The Institute relies for guidance, support and collaboration upon the following distinguished academics drawn world-wide:

- Dr Mads Andenas, PhD (Cantab) (UK), Senior Lecturer in Financial Markets Law and Co-Director of Centre of European Studies, King's College, London. Expertise: European Financial Law.
- Professor William Blair, QC (UK). See Advisory Board above. Expertise: U.K. Financial and Commercial Law.
- Dr. Baekin Cha (Korea), Research Fellow, Korea Institute of Finance, Seoul. Expertise: Korean Financial Law.
- Professor Diego Bunge (Argentina), Estudio Bunge and University of Buenos Aires, Graduate Banking Law Programme. Expertise: Argentine Commercial and Financial Law.
- Professor Richard Dale (UK). See Advisory Board above. Expertise: International Finance.

- Professor E P Ellinger (Singapore). See Advisory Board above. Expertise: Banking and Commercial Law.
- Professor John Farrar (Australia). Bond University Law Faculty. Expertise: Corporate and Securities Law.
- Professor Benjamin Geva (Canada). See Advisory Board above. Expertise: Comparative Commercial Law and Payment Systems.
- Professor Mario Giovanoli (Switzerland), Legal Advisor, Bank for International Settlements. Expertise: International Monetary Law
- Professor Angela Itzikowits (South Africa), Wits University Law Faculty (Johannesburg). Expertise: Banking Law and International Financial Crimes.
- Professor Hideki Kanda (Japan). See Advisory Board above. Expertise: Japanese Financial Law.
- Professor Roberta Karmel (US). Center for International Business Law, Brooklyn Law School. Expertise: Securities Regulation/International Financial Regulation.
- Professor Hsin-fa Lin (Taiwan), National Chengchi University Insurance Department, Taipei. Expertise: Insurance Law and Regulation.
- Professor Geoffrey Miller (US). See Advisory Board above. Expertise: US and Central Banking Law.
- Mr. Kitisak Prokati (Thailand), Associate Professor, Thammasat Law Faculty (Bangkok). Expertise: Thai Commercial and Financial Law.
- Professor Ian Ramsay (Australia). See Advisory Board above. Expertise: Corporate Governance.
- Professor Jeswald W. Salacuse (US), Professor of International Law, Fletcher School of Law and Diplomacy. Expertise: Emerging Markets.
- Professor Hal Scott (US). See Advisory Board above. Expertise: International Financial Law.
- Dr. Brian Semkow (HK). Associate Professor, HK University of Science and Technology. Expertise: East Asian Financial Law.
- Professor Stanley Siegel (US), NYU Law School. Expertise: Corporate Law and Accounting.
- Professor Marc I Steinberg (US). See Advisory Board above. Expertise: US and International Securities Law.
- Professor Ted Tyler (HK), City University of Hong Kong, School of Law. Expertise: HK Securities and Business Law.
- Professor Rolf Weber (Switzerland), Zurich University Law Faculty. Expertise: Swiss and European Banking and Business Law.
- Professor Jane Winn (US), Centre for Pacific Rim Legal Studies, SMU. Expertise: Comparative Commercial Law and Informational Technology.
- Professor Peter Winship (US), SMU Law School. Expertise: International and US Commercial Law.
- Professor Philip Wood (UK). See Advisory Board above. Expertise: International Financial Law.
- Professor Wu Ziphan (PRC). See Advisory Board above. Expertise: PRC Financial Law.

Participating Professional Fellows.

The Institute is actively assisted by a group of expert practitioners and civil servants, including the following:

Dr. Chung-Hsing Chen, Taiwan Rating Agency, Taipei
Ms. Pamela Lameroux, Chief Operating Officer, HK Mortgage Corporation
Dr. Lawrence Liu, Consultant, Lee & Li, Taipei
Mr. Michael Liu, Partner, Allen & Overy (HK)
Ms. Alexandra Lo, Legal Staff, HKSFC
Mr. Robert SK Lee, Prosecution Office, HK Department of Justice
Mr. Ian Tokley, Partner, Herbert Smith (HK)
Mr. Michael Vidler, Partner, Paul Kwong Ho, Hong Kong
Postgraduate Research Fellows.

The Institute is assisted by an international group of dedicated research fellows:

SJD candidates (corporate and financial law) (2)

Mr. Douglas Arner, JD, LL.M, PhD candidate, London. Honorary Lecturer, Faculty of Law, HKU.

Mr. Christopher Olive, JD, LL.M, PhD candidate, London.

Mr. Kai Chen, LL.B, LL.M, SJD candidate, SMU.

Senior Law Student Fellows.

The Institute's Leadership is assisted by two HKU Law students:

(To be appointed)

Research Assistant - to be appointed, subject to funding.

Jo E Chan, LL.B (HKU)

Administrative Officer - to be appointed, subject to funding.

Information Technology Officer - to be appointed, subject to funding.

**SUPPORT FOR HKU FACULTY OF LAW'S
ASIAN INSTITUTE OF INTERNATIONAL FINANCIAL LAW**

Specific indications of interest may be discussed with the Institute's Co-Executive Director:

Mr. Say Goo
Associate Professor
Faculty of Law
University of Hong Kong
Pokfulam, Hong Kong

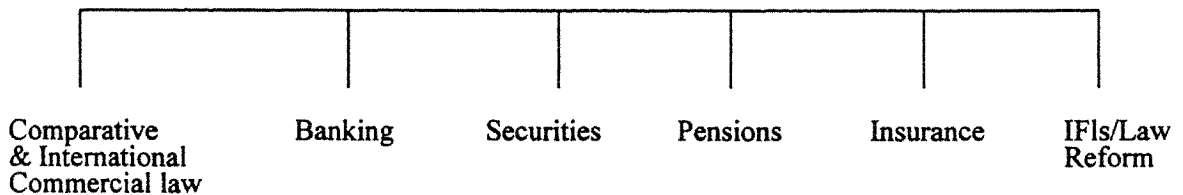
Phone: 85-2-2859-2944
Fax: 85-2-2559-3543
Email: shgoo@hkucc.hku.hk

Summary of Organisational Chart

ASIAN INSTITUTE OF INTERNATIONAL FINANCIAL LAW
(based at the HKU Faculty of Law)

<u>Advisory Boards:</u>	Academic: 26 members Professional: 10 members
<u>President:</u>	Mr. Anthony Neoh, QC, SC
<u>Co-Executive Directors:</u>	Prof. J. Norton Mr. Say Goo (Chairman)
<u>Deputy Executive Directors:</u>	Ms. Lusina Ho (Commercial Law) Ms. Katherine Lynch (Dispute Resolution) Mr. Philip Smart (Insolvency) Mr. Richard Wu (HK Financial Law) Mr. Zhang Xian Chu (PRC Financial Law)
<u>Professorial Fellows:</u>	a. HKU Financial Law Group (21) b. HKU Consulting Law Members (5) c. HKU Interdisciplinary Faculty Members (3) d. External Professorial Fellows (8)
<u>Professional Fellows:</u>	8 Members
<u>Postgraduate Research Fellows:</u>	5 Members
<u>Senior Law Student Fellows:</u>	2 Members
<u>Research Assistant:</u>	TBA
<u>Administrative Officer:</u>	TBA
<u>Information Technology Officer:</u>	TBA

Institute's Areas of Activities



**SMU Institute of International Banking
and Finance**

Dallas, Texas

SMU INSTITUTE OF INTERNATIONAL BANKING AND FINANCE

The SMU Institute of International Banking and Finance was established in 1982, with the support and encouragement of then Dean Jeswald W. Salacuse and SMU Provost Dr. Hans Hillerbrand. The Institute, based at the SMU School of Law, was to be a cooperative University venture (supported in part through provostial funds, private contributions and Law School funds) involving the interdisciplinary talents of the School of Law, the Dedman College Departments of Economics and Political Science, the Edwin L. Cox School of Business, and the Southwest Graduate School of Banking.

Initial Advisory Board

From 1982-1988, the Institute relied heavily upon the advice of a distinguished Advisory Group including the following:

Mr. Robert Carswell, former Managing Partner, Sherman & Sterlin, New York
Sir Joseph Gold, Senior Consultant and former General Counsel, IMF, Washington, D.C.;
Mr. Jess T. Hay, former Chairman, Lomas & Nettleton Financial Corp., Dallas;
Professor John H. Jackson, then Hessel Yntema Professor of Law, University of Michigan Law School, Ann Arbor;
Mr. Dennis A. Weatherstone, former Chair, The Morgan Bank and former Chair of York;
Mr. Lawrence A. Weinbach, former Senior Partner, Arthur Andersen & Co., New York;
Geoffrey M. White, Senior Partner, Clifford-Turner, London

General Objective and Strategy

The general objective of the Institute was for the Law School to develop, within the University and in conjunction with other Schools and Departments of the University, a leading academic center in the area of international banking and finance. To accomplish this objective, the Institute sought (i) to promote scholarly research, teaching and writing in the area of international banking and finance; (ii) to develop a program of scholarships for graduate students interested in international banking and finance; (iii) to serve as a permanent and multi-disciplinary institute of the highest quality dedicated to the furtherance of knowledge and education in the international banking and finance areas (e.g., through the presentation of an Annual Symposium and other relevant programs, and through high quality interdisciplinary publications); and (iv) to provide a common meeting ground and forum for executives, financiers, lawyers, accountants, economists, civil servants and academics involved in international financial matters. More specific objectives of the Institute were to be determined, from time to time, by the Dean of the Law School upon consultation with the Advisory Board and other involved University Deans and Department Heads.

The Early Conferences

In implementing the above strategy, the Institute conducted a series of major policy-oriented, interdisciplinary conferences between the period of November 1982 and January 1988. These include the following:

First Institute, "Internationalization of U.S. Capital Markets," (November 1982).
Second Institute, "Prospects for the Multinationals in the 1980s," (November 1983).
Third Institute, "World Trade and Trade Finance," (November 1984).
Fourth Institute "Prospects for International Lending and Reschedulings," (April 1986).

Fifth Institute "International Tax Planning After the Tax Reform Act of 1986," (Jan. 1988)

The Early Publications

From these various Conferences came the following four major book publications:

Prospects for International Lending and Reschedulings (vol. 3 of Matthew Bender "International Finance Series," 1988, 33 chs., approx. 1000 pages).

European Economic Community: Trade and Investment (vol. 2 of Matthew Bender "International Finance Series," 1986, 25 chs., approx. 800 pages).

International Tax Planning After the Tax Reform Act of 1986 (vol. 4 of Int'l Finance Series, 9 chapters, approximately 425 pages) (1988).

World Trade and Trade Finance (vol. 1 of Matthew Bender "International Finance Series," 24 chs., approx. 700 pages).

In addition, these conferences generated at least ten stand-alone published, scholarly articles. These early efforts of the Institute were consistent with the major push in the late 1970s and early to mid-1980s for Dallas and SMU to attain a significant international dimension. In effect, the Institute was part of a "partnership" concept between the University and the local business and financial communities.

The Crises Years

Unfortunately, with the mid-and late 1980s and early 1990s, the University and the Dallas Community found themselves in significant economic distress. These major systemic problems in the local, state and regional economies and within the University caused a retrenchment of the University's international activities and of the funds available for the Institute and for other planned University international activities (including, a University Center for International Studies, which had been in its final planning stages in 1985). All this meant, in effect, that the SMU Institute of International Banking and Finance had to fend for itself to "limp along" for a period of time and that the Institute become retrenched more within the Law School.

Further Conferences and Publications (1989-96)

Yet, during this unfortunate period in the history of Dallas and SMU, the Institute (through various of its Faculty participants) did try to keep its name and objectives active. For example, the Law School, from 1989 through 1996, secured the co-sponsor by the Institute of five major international conferences abroad. These five international conferences were as follows:

International Dimensions of Asset Securitization, Centre for Commercial Law Studies, Univ. of London, (July 1989).

Prospects for International Banking and Finance in the 1990s (July 9-11, 1990) and Global Financial Institution Restructuring (July 12-13, 1990), Centre-for-Commercial Law Studies (London).

Joint Conference (London, U. of Buenos Aires, SMU) on International Banking and Finance, Sept 1994, Buenos Aires.

Asset Securitization and Developing Economies (joint Conference, CCLS, London, UBA & SMU, Buenos Aires, Sept 1995).

"Prospects for MERCOSUR" (SepL 1996, Joint Conference, CCLS, London, UBA & SMU, Buenos Aires).

The Recent Publications

These conferences have produced additional books and article publications under the co-sponsorship of the Institute. The resulting book publications from these conferences embrace the following:

Asset Securitization: International and Comparative Dimensions Financial and Legal (Basil Blackwell Publications 14 chapters 1991) (2nd edition published in 1995 by Lloyds of London Press).

International Finance in the 1990s: Challenges and Opportunities; (15 Chapters; Blackwell 1993).

The Reactivation and Current Conferences and Publications

With the recent recovery of the Dallas and Texas economies, with renewed local business interests in international business/ finance, and with a new University President (R. Gerald Turner) Provost (Ross C Murfin), and Law Dean (John Attanasio), all of whom are fully committed to securing a significant international dimension for SMU and a closer partnership with the Dallas business/financial communities, the time has become ripe for a substantive "reactivation" of the Institute. A part of the SMU Law School's commitments to enhancing its international dimension (in light of its recent Long-term Strategic Plan) is the revitalization of the Institute.

For example in 1997 and 1998, the Institute was involved as sponsor or co-sponsor of major international conferences in the international finance area in Madrid, London, Dallas, Beijing and Hong Kong. Further the Institute was responsible for a major Yearbook of International Financial and Economic Law and a major book series in International Banking and Financial Law. To date, in connection with the foregoing, the Institute recently has published (or is publishing the following):

Yearbook of International Financial and Economic Law - 1996 and 1997 (Kluwers International)

Banking Law Reform in Latin America: (to be published by Kluwers International in 1999).

Finance and Financing in Latin America: Selected Legal Aspects (to be published by Kluwers International in 1999).

The above referenced Yearbook, which is jointly published with the London Institute of International Banking, Finance and Development Law, is the Institute's "flagship" publication. The International Law Review Association of SMU and Student Fellows of the Institute assist in the editing of the Yearbook and of the book series.

The Financial Law Group

In this context, the following full-time and adjunct members of the Law School Faculty have come together to form a Financial Law Group component of the reactivated Institute. These Law Faculty members are as follows:

Professor Alan Bromberg (Securities)
Professor Jeffrey Gaba (Environmental)
Professor Cliristopher Hanna (Taxation)
Professor John Lowe (Oil & Gas/ Energy)
Professor Joseph Norton (Banking/Finance)
Professor Ellen Pryor (Insurance)
Adjunct Professor Robert Rendell (International Banking)
Professor Marc Steinberg (Securities)
Professor Jane Winn (Commercial/Information Technology)
Professor Peter Winship (Commercial/Trade)

Similar to the Law School's Pacific-Rim Centre and Law Institute of the Americas , the Institute is assisted by a select and highly experienced group of Professorial and Professional Fellows. Details on the members of the Institute's Advisory Board and Fellows is set forth below.

The Interdisciplinary Components

The Law School recently has engaged in active discussions with Professor Cal Jillson, Head of the Dedman Department of Political Science, with Professor Shlomo Weber, Head of the Department of Economics at Dedman College, and Professor Rex Thompson, Head of the Finance Department at the Edwin L. Cox School of Business, with respect to these other SMU Department's/School's future involvement in the reactivated Institute.

Future Plans

In October 1997 a major University, interdisciplinary conference (involving the Institute and the SMU Tower Center) and two special symposium issues of the Law School's NAFTA Review were embarked upon on a collaborative bases among the SMU Law School, Political Science Department, and Economics Department. Further, it is hoped that the relationships formed in recent years with the London Institute and Centre for Commercial Law Studies at the University of London and the Graduate Banking Program at the University of Buenos Aires and a 'new relationship' formed in 1997/98 with the Law and Business Schools at the University of Beijing and the Law faculty at the University of Hong Kong will make it possible for the Institute to embark upon more substantive and international oriented activities. The Institute is also participating in law reform projects involving the Emerging Markets Committee of the International Organization of Securities Commissions (IOSO), the Latin American Economic System (SELA), the Southern African Development Community, the Ministry of Economy of Egypt, and the Legal Department of the Bank of Thailand.

Membership and Staff

A team of international experts drawn from the SMU Law School Faculty and externally comprise of Institute Faculty in connection with it's courses, conferences and roundtables, lecture series, journals and book series, and postgraduate academic lecturing and research.

Chairperson

- Alan R. Bromberg, SMU Distinguished University Professor of Law. Expertise: securities and capital market issues.
- Sir Joseph Gold, Honorary Institute's Chairperson, former General Counsel and Senior Consultant, International Monetary Fund. Expertise: international monetary law.

Ex Officio Board Members

- Alan R. Bromberg. See above.
- Marc I. Steinberg (President). See below.
- Joseph J. Norton (Executive Director). See below.
- Peter Winship (Executive Director). See below.

Internal Board Members

- Professor C. Jillson, Head of SMU Dept. of Political Science, Dedman College, SMU.
- Professor Rex. Thompson, Head of SMU Dept. of Finance, Edwin L. Cox School of Business, SMU.
- Professor S. Weber, Head of SMU Dept. of Political Science, Dedman College, SMU.
- Professor Jane Winn. See below.

External Board Members

- Professor S. Gao, Director, Chinese Banking Research Institute, Hainan, P.R.C. and PhD. Adviser, Beijing University.
- Professor M. Giovanoli, University of Lausanne and Legal Adviser, Bank of International Settlements, Basle
- Dr. Michael Gruson, Senior International Finance Partner, Sherman & Sterling, New York City
- Professor Cynthia Lichtenstein, Boston College School of Law
- Professor F.R. Malan, Director, Banking Law Institute, and Supreme Court Justice, Johannesburg
- Herbert D. Vest, Chairman, H.D. Vest Financial Services, Inc., Dallas, Texas
- Geoffrey White, Senior International Finance attorney, Clifford-Chance, London
- Professor Philip Wood, CCLS, University of London and Senior International Banking Partner, Allen & Overy, London

Institute's Presidents

- Marc I. Steinberg, Rupert and Lillian Radford Professor of Law (SMU). Expertise: international and domestic securities and capital market issues.
- Dr. Daoud Khairallah, Honorary President of Institute, Deputy General Counsel, The World Bank. Expertise: international financial law.

Institute's Executives and Associate Executive Directors

- Joseph J. Norton, Executive Director of Institute for Administrative Affairs, James L. Walsh Distinguished Faculty Fellow and Professor of Law (SMU), Sir John Lubbock Professor (London). Expertise: international banking and finance law.
- Christopher H. Hanna, Associate Executive Director of Institute for International Tax Matters, Associate Professor of Law and Co-Director Pacific Rim Legal Studies (SMU)
- Ming Shen, Associate Executive Director of Institute for Greater China Matters, Visiting Professor (SMU's Centre for Pacific Rim Legal Studies)
- G.N. Olson, Associate Executive Director for Special Projects
- Jane Kaufman Winn, Associate Executive Director of Institute for International Technology Matters, Associate Professor of and Co-Director Pacific Rim Legal Studies (SMU).
- Peter Winship, Executive Director of Institute for Law Reform, James Cleo Thompson Sr. Trustee Professor of Law (SMU). Expertise: international commercial law.

Participating Professorial Fellows

- Ernesto Aguirre, Senior Legal Counsel, IMF, Washington D.C. Expertise: International monetary law and banking law reform
- Mads Andenas, Senior Lecturer in financial markets law, King's College (London). Expertise: financial markets law and international financial institutions
- Raj Bhala, Professor of Law, George Washington University. Expertise: international trade law and international banking law/financial law
- Jagdeep Bhandari, SMU Visiting Law Professor; former international economist, IMF. Expertise: IFI's and international exchange markets
- Diego C. Bunge, Adjunct Professor and Director Graduate Banking Law Program (Univ. Buenos Aires). Expertise: international business and commercial law, MERCOSUR
- Feng Qi Cao, Professor and Deputy and Dean, Guanghua School of Management, Peking University; Co-director Research Center for Finance and Securities of Peking University, Beijing P.R.C. Expertise: Chinese business and finance law
- Werner Ebke, Professor of Intl Business Law (Univ. of Konstanz, Germany). Expertise: Intl business law and international taxation
- L. Fan, Associate Professor of banking and financial law, Northwest University (Xian, PRC). Expertise: Chinese financial law
- Alejandro M. Garro, Director of Latin American Legal Studies and Associate Research Fellow, Parker School of Foreign and Comparative Law (Columbia). Expertise: international commercial law and human rights; Latin American legal studies

- Benjamin Geva, Professor of Law, Osgoode Hall School of Law, Toronto. Expertise: International payments and financial transactions
- Christopher H. Hanna (see above)
- Christos Hadjiemmanuil, Lecturer in law, London School of Economics and Political Science. Expertise: European financial and monetary law
- Ndiva Kofele-Kale, SMU Associate Professor of Law. Expertise: international dispute resolution and human rights
- Rosa Lastra, Lecturer in international financial and monetary law, CCLS (London). Expertise: International financial and monetary law
- Henry J. Lischer, SMU Professor of Law. Expertise: international taxation and technology issues
- John S. Lowe, SMUs George W. Hutchison Professor of Energy Law. Expertise: international energy/environmental law
- John J. Mylan, SMU Professor of Law. Expertise: international taxation
- Joseph J. Norton. See above
- Kitisak Prokati, Associate Professor of Commercial Law, Thammasat University (Thailand). Expertise: Comparative commercial law
- Ellen Smith Pryor, SMU Associate Professor of Law. Expertise: insurance services and activities
- Ming Shen, see above
- Marc I. Steinberg, see above
- George A. Walker, Lecturer in UK and European banking law, CCLS (London). Expertise: UK and international financial law
- Ming Wan, commercial judge, P.R.C. Expertise: Chinese and Asia capital markets issues
- Jane Kaufman Winn, see above
- Peter Winship, see above
- Ziphan Wu, Dean and Professor Financial Law, Peking University Law School; Co-director, Research Center for Finance and Securities of Peking University, Beijing, P.R.C. Expertise: Chinese banking and securities law

Senior (Postgraduate) Research Fellows

Douglas Arner. Expertise: financial crises

Kai Chen. Expertise: Chinese financial law

Eun Yee Chung, Expertise: Korea and Finance. Student Coordinator for Institute

Byung-Tae Kim, Expertise: Korean financial law

Matthew Morgan, Expertise: U.S. banking and securities laws

Christopher Olive, Expertise: U.S. and international financial law

Rigin Ractiamat, Expertise: Indonesian banking law

Tull Traisorat, Expertise: Thailand financial law

Sungchul Shin, Expertise: International capital markets and Korean securities law

Participating Professional Fellows

- David Barbour, Head of Asset Securitization/Structured Finance, Andrews & Kurth, LL.P (Texas and London)
- Y. Huang, Head of International Banking Law Department, Bank of China (Beijing)
- Laurence Johnson, Senior Intl Finance Partner, Baker & McKenzie (Dallas, Texas)
- Julian Nihill, Senior International Attorney, Gardere & Wynne, Dallas, Texas
- Timothy Powers, International Banking Partner, Haynes & Boone, Dallas, Texas

**London Institute of International Banking,
Finance and Development Law**

London, United Kingdom

LONDON INSTITUTE OF INTERNATIONAL BANKING, FINANCE AND DEVELOPMENT LAW

The London Institute of International Banking, Finance and Development Law (“London Institute” or “Institute”) is a London-based, education-driven institute whose broad objectives are: (i) excellence in scholarly research, research seminars, publications (including book series, study and practice guides, research paper series, and an annual review), and high level executive/professional development seminars in the international banking, finance and development law areas, and (ii) excellence through its international resource component (“IRC”), respecting the provision of advice and counsel to international financial and development institutions, European Union authorities, and governmental bodies interested in banking and finance law reform in emerging, transitioning and developing countries.

The Institute was founded in 1993 as the idea of several colleagues within the CCLS and elsewhere in the University of London and was formally privately incorporated in 1996. The Institute acts to coordinate international activities involving academics and others interested in the fields of international banking, finance, and development law. Among other educationally-related functions, the Institute assists the International Financial Law Unit at the Centre for Commercial Law Studies at Queen Mary and Westfield College, University of London, in directing research seminars, professional conferences, executive training sessions, law reform and consulting projects, and major journals and book series.

The London Institute’s Executive Director and founding member is Professor Joseph J. Norton, S.J.D., D.Phil., the Sir John Lubbock Professor of Banking Law at the University of London; the James L. Walsh Distinguished Faculty Fellow and Professor in Financial Institutions Law at the Southern Methodist University School of Law in Dallas, Texas; and currently the Vice Chancellor’s Distinguished Visiting University Professor of Law, The University of Hong Kong (Jan. 1, 1999 to Dec. 31, 2000). The Executive Director is responsible for formulating and coordinating policies, recommending projects, and approving publications.

Professor Norton is assisted in the Institute’s varied activities by a distinguished group of over thirty associating “Institute Fellows”, comprising internationally recognised experts drawn from all around the world. The related activities of the Fellows have taken them to virtually all corners of the globe.

The Institute receives advice and guidance from an Advisory Council comprising: Mr Raymond Auerback; William Blair, Q.C.; Professor Ross Cranston, M.P.; John Edwards; Professor Dr. Norbert Horn; Mr Huang Yangxin; Professor (Hon.) Roberto Maclean; Professor (Justice) Franz Malan; Mr Andre Newburg; Mr Hugh Pigott and Professor Philip Wood.

The Institute conducts its activities as a *independent international teaching and research institute*, emphasising UK, EU, international and comparative banking, financial and other economic law issues and banking, finance, and other economic law issues pertaining to developing, emerging and transitioning economies. The Institute and its associates are engaged in numerous research, publication, consultation, law reform and conference activities on a worldwide basis.

In addition, from time to time, the London Institute makes grants to scholars and to research institutions pursuing worthy research projects in the emerging markets, international financial law, and European financial law areas and engages in educational projects in various developing areas internationally.

The internal and external goals of the Institute are:

1. To establish a private banking and finance law Institute which is without peer in London and the UK and which regularly involves co-ordinated research, consulting, conference and publication activities (on private and public law aspects and on UK, EU, international and comparative topics) of associating Fellows actively engaged in designated Institute projects.
2. To establish, in co-operation with the Centre for Commercial Law Studies (CCLS) at Queen Mary & Westfield College, University of London, one of the leading publication centres on banking, financial, tax, and emerging markets law in the world through control over, or active involvement in, leading book series, journals and research paper series - in which the Institute's associating Fellows and Advisory Board, and other selected international scholars contribute.
3. To establish, in co-operation with the CCLS, a "mecca" (*i.e.*, meeting place) for the exchange of ideas and discussion of key issues in banking, financial, tax, and emerging markets law areas by leading academics, practitioners, financiers and governmental and inter-governmental officials, through the conduct of high-level conferences, research seminars, exchange programmes, distinguished visitors series, and designated book publications, etc.
4. To establish, with the CCLS, a vehicle for the world-wide dissemination of current knowledge and developments in the banking, financial, tax, and emerging markets law areas (both private and public aspects), through special certificated training and diploma programmes and active educational participation with leading educational institutions abroad -- all with an emphasis on reaching developing, emerging and transitioning economies.
5. In conjunction with the CCLS, to create a world-class "team" for dealing with meaningful economic law reform projects in emerging economies (with a particular emphasis on Central and Eastern Europe, the former Soviet Union, Latin America, Southern Africa, and South East Asia).

To date, the Institute has successfully increased significantly the range of its *external activities* (*e.g.*, Board of International Scholars activities, external educational relationships, annual overseas conferences, etc.).

INSTITUTE ACTIVITY SUMMARY

- ❖ World-class and internationally-drawn Advisory Board and associating Fellows
- ❖ Significant research and publication programme
- ❖ Ongoing Institute research projects: private and public law aspects of a common European currency; Financial and Tax law reform in Central and Eastern Europe; IOSCO/Emerging Markets; Southern Africa, Southeast Asia and Mercosur Region; and various projects of numerous visiting Fellows
- ❖ Major annual international research/seminar conference activities in London, Central and Eastern Europe, the United States, Latin America, Southern Africa and the Pacific Rim
- ❖ Ongoing special Essay Series
- ❖ Co-nsponsorship of a Distinguished Lecture Series
- ❖ Co-operative editorship of or other regular involvement in major international journals

- ❖ Major publication series with leading international publishers: UK banking, international banking, international economic development law, and European financial law (approximately 6-8 new or revised volumes being produced annually)
- ❖ Links with UK, US and EU and other governmental authorities and various intergovernmental authorities and international financial/monetary institutions
- ❖ World-wide links with major academic institutions in banking and financial law area

LONDON INSTITUTE PRIVATE BANKING AND FINANCE LAW RESEARCH OPPORTUNITIES

The Institute prides itself on being a leading *institute* (of international stature) in banking, finance, and emerging market law. Each year, the Institute and its associating Fellows supervise a number of academic research projects. Through the Institute's network of international contacts, its associates have access to major law and economic libraries, and are also given access to up-to-date computer legal research facilities and to world-wide expertise and research resources. The Institute also has co-operative research arrangements with numerous non-legal, bank/finance and economic research departments and institutes. Moreover, the Institute's own Essay Series, various book series, and its contacts with leading international book publishers and journals offer publication possibilities for postgraduate students producing high quality manuscripts.

Recent essays and research projects have included:

Central Bank Use of Derivatives
 European Monetary Union
 European Banking Law
 Chinese Banking Law
 Korean Banking Law
 Banking Law in Thailand
 Regulatory Reform of Insurance in China and Japan
 MERCOSUR and Financial Harmonisation in Latin America
 APEC and Regional Integration in the Pacific
 Banking Supervision and the Bank of England
 The Implications of the Mexican Peso Crisis for the Regulation of Financial Markets
 Problems of Legal Risk Analysis in Real Estate Transactions and Finance
 Bank Insolvency
 The Audit Function Role in the Bank Regulatory Regime
 International Construction Consortiums.

In addition, each associating Fellow of the Institute engages in significant research projects. Examples of current research projects include:

Security and Debt Recovery in Bulgaria, Romania and the Czech Republic
 Legal Structure of Corporate Finance in Hungary, Poland and Russia
 European Monetary Union
 Regulation of Financial Conglomerates
 Central Banking and Banking Regulation in Developing Countries.
 Financial Law Reform in Southeast Asia
 Commercial Law Reform in Southern Africa.

Moreover, each year, the Institute invites visiting scholars to join the Institute's research efforts. Further, on a semi-annual basis, the Institute organises and co-sponsors research seminars on legal

issues in the banking, finance, taxation, and emerging markets areas. Examples of currently planned research seminars include:

Financial Services Liberalisation and Prudential Supervision
Risk Management in Financial Services in the Chinese Economic Area
The Role of IOSCO in Emerging Markets
Bank Insolvency Law Reform.

It is expected that each of these research seminars will produce a high quality book publication, several publishable articles, and ideas for further Institute research.

ADVISORY COUNSEL

The Institute's Executive Director and Advisory Counsel comprise some of the leading experts in domestic, European and International banking and finance law, and in the areas of economic development law and emerging markets.

Prof. Joseph J. Norton, Executive Director of the London Institute of International Banking, Finance and Development Law; Sir John Lubbock Professor of Banking Law at the University of London; James L. Walsh Distinguished Faculty Fellow in Financial Institutions Law and Professor of Law, SMU School of Law (Dallas, Texas); currently Vice Chancellor's Distinguished Visiting University Professor of Law, The University of Hong Kong (1999-2000); Senior Fellow, Institute of European Finance; Sometime Visiting Professor - Institute of International Business Law (Muenster, Germany).

Raymond Auerback, formerly legal adviser (for ten years) to Commonwealth Development Corporation; Partner, Andrews & Kurth (London).

William Blair, QC. 3 Verulam Buildings and Visiting Professor, CCLS and London School of Economics and Political Science.

Prof. Ross Cranston, UK Solicitor General; Member of the House of Commons of the United Kingdom, Former Cassel Professor of Commercial Law, London School of Economics and Political Science.

John Edwards, former senior international partner and presently a consultant at Linklaters & Paines.

Prof. Dr. Norbert Horn, Professor of Law and Director of Banking Law Institute and Law Centre for Eastern Europe and International Cooperation, University of Cologne.

Huang Yangxin, Deputy General Manager and head the Legal Affairs Division of the International Department of the Bank of China.

Prof. (Justice) Franz Malan, Justice of the Supreme of South Africa; Visiting Professor and Director of Banking Law Institute, Rand Afrikaans University, Johannesburg, South Africa.

Prof. (Hon.) Roberto Maclean, Former Dean, Faculty of Law, University of Lima; former Peruvian Ambassador to US and Deputy Director of Central Bank of Peru; Judicial Specialist, World Bank; Visiting Professor of Law and President of the NAFTA Law Centre, SMU School of Law, Dallas, Texas.

Andre Newburg, first and former General Counsel, European Bank for Reconstruction and Development; former partner, Cleary Gottlieb, Steen & Hamilton, in New York, Paris, Brussels and Hong Kong.

Hugh Pigott, principal of the Centre for Law Reform Studies. Former senior partner, international banking group, Clifford Chance.

Prof. Philip R. Wood, Senior banking partner, Allen & Overy (London) and Visiting Professor of International Financial Law, CCLS.

FELLOWS OF THE LONDON INSTITUTE

The associating Fellows of the London Institute comprise some of the leading experts in domestic, European and International banking and finance law, and in the areas of economic development law and emerging markets.

PROFESSORIAL FELLOWS

Prof. Raj Bhala, George Washington University, Washington, D.C.

Prof. Diego Bunge, Director, Graduate Banking Programme, University of Buenos Aires and Partner, Estudio Bunge Asociados, Buenos Aires.

Prof. Richard Dale, Professor of International Banking & Financial Institutions, University of Southampton.

Prof. Marc Dassesse, Professor at Free University of Brussels (ULB), and Partner, McKenna & Cuneo, Brussels.

Prof. Dr. Werner Ebke, Professor of International Business Law, University of Konstanz

Prof. E.P.M. Gardener, Professor and Chairman of Accountancy, Banking and Economics at University College of North Wales; Director, Institute of European Finance.

Dr. Alejandro Garro, Director Latin American Law Programme, Parker School of International & Comparative Law, Columbia University, New York.

Prof. Benjamin Geva, Professor of Law, Osgoode Hall Law School, York University, Toronto.

Prof. Stephen Huber, Professor of Banking Law and Director of Graduate Programme, University of Houston Law Centre, Texas.

Prof. Roberta S. Karmel, Professor of Law and Co-Director, Center for the Study of International Business Law, Brooklyn Law School; and former Commissioner of the US Securities and Exchange Commission and public director of the New York Stock Exchange.

Prof. Jan Kleineman, Professor of Law, Faculty of Law, Stockholm University.

Prof. Ndiva Kofele-Kale, Professor of Law, SMU School of Law.

Prof. Cynthia Lichtenstein, Professor of Law, Boston College Law School.

Prof. Robert Pennington, Professor Emeritus of Commercial Law (and former Law Dean), University of Birmingham.

Prof. Kittisak Prokati, Director, Institute of Comparative Law and Public Policy; Director, Center for German Legal Studies; Head, Department of Socio-Historical and Philosophical Studies of Law, Faculty of Law, Thammasat University, Bangkok, Thailand.

Prof. Jeswald W. Salacuse, Henry J. Braker Professor of Commercial Law and former Dean at the Fletcher School of Law and Diplomacy, Tufts University.

Dr. M. Shen, Legal Consultant and Professor of Law, Beijing

Prof. Stanley Siegel, Professor of Law, New York University; Professor of Law, Central European University, Budapest.

Prof. Marc I Steinberg, Rupert and Lillian Radford Professor of Law, SMU School of Law (Dallas, Texas); President, SMU Institute of International Finance and Banking.

SENIOR FELLOWS

Dr. Mads Andenas, Senior Lecturer and Director of Centre of European Law, King's College London.

Dr. Christos Hadjiemmanuil, Lecturer in Law, London School of Economics and Political Science.

A. Itzikowitz, Senior Lecturer in Banking Law, Witwatersrand University, South Africa.

Dr. Rosa Maria Lastra, Lecturer in International Financial and Monetary Law, CCLS.

Gerald Olson, former law partner in a major Texas law firm and President of a large diversified real estate development and investment firm.

M. Rochelle, Adjunct Professor of Bankruptcy Law, SMU Law School, Dallas, Texas.

Georgi Spasov, Associate Professor of Banking Law, University of Sofia, Bulgaria.

Joel Trachtman, Associate Professor of International Law, Fletcher School of Law and Diplomacy, Boston, Massachusetts.

Dr. George Walker, Lecturer in UK and European Banking Law, CCLS.

Masao Yanaga, Associate Professor of Law, Institute for Advanced Studies of Business Law, University of Tsukuba.

FELLOWS

Douglas Arner, Sir John Lubbock Support Fund Fellow in International Capital Markets Law, CCLS; Honorary Lecturer, The University of Hong Kong; Consultant, Office of the General Counsel, European Bank for Reconstruction and Development.

Jorge Guira, Research Fellow in Latin American Financial Law.

Matthew Morgan, Associate, Allen & Overy, London.

Anna Mörner, Lecturer in Financial Law, CCLS.

Christopher Olive, Research Fellow in International Financial Law; Visiting Fellow in Financial Law, CCLS.

Young Shim, Research Fellow in Korean Financial Law.

Tull Traissorat, Ministry of Foreign Affairs, Thailand; Research Fellow in Thai Financial Law

PUBLICATIONS: Summary of Institute Book Publications

A. Lloyd's of London Press - Banking Law Series
(Prof. J. Norton - Series Editor)

- R. Cranston (ed.) *Banks, Liability and Risk* - 2nd Edition (1995)
- J. Norton (ed.) *Cross-Border Electronic Banking* (1995)
- R. Auerback, J. Gaba
& J. Norton (eds.) *Environmental Liability for Banks* (1995)
- J. Norton, P. Spellman
& M. Dupler (eds.) *International Asset Securitisation* (1995)
- R. Cranston (ed.) *The Single Market and the Law of Banking* - 2nd Edition
(1995)
- J. Norton (ed.) *Banks: Fraud and Crime* (1994)
- W. Hedley *Bills of Exchange and Bankers' Documentary Credits* - 2nd
Edition (1994)
- R. Cranston (ed.) *European Banking Law: The Banker-Customer Relationship* (1993)
- R. Cranston (ed.) *Banks and Remedies* (1992)
- J. Norton (ed.) *Bank Regulation and Supervision in the 1990s: International
and Comparative Dimensions* (1992)
- C. Hadjiemmanuil *Banking Regulation and the Bank of England* (1996)

Other Titles Commissioned:

- J. Norton (ed.) *Bank Regulation and Supervision in the 1990s* - 2nd Edition
- Banks: Fraud and Crime* - 2nd Edition
- R. Cranston (ed.) *European Banking Law: The Banker-Customer Relationship*
- 2nd Edition
- R. Cranston (ed.) *Banks and Remedies* - 2nd Edition

B. Kluwer International Economic Development Law Series
(Prof. J. Norton - Series Editor)

- J. Norton & M. Andenas (eds.) *Emerging Financial Markets and Secured Transactions* (1997)

- H. Sarie-Eldin *Consortia Agreements in the International Construction Industry* (1996)
- J. Norton & M. Andenas (eds.) *Emerging Financial Markets and the Role of IFI's* (1996)
- B. Sodipo *Piracy and Counterfeiting* (1996)
- J. Norton *NAFTA and Beyond* (1995)
- N. Kofele-Kale *International Law of Responsibility for Economic Crimes* (1995)

Other Titles Commissioned:

- L. Fan, Y. Huang & M. Wan (eds.) *Developing Financial Laws in the PRC: Risk and Risk Control*
- Y. Kodama *APEC and Asia Pacific Integration*
- J. Kotvis (ed.) *NAFTA and the Environment*
- J. McMahon *Development Cooperation Policies of the EC*
- J. Norton, M. Andenas & M. Footer (eds.) *International Law in the 21st Century: A Tribute to Professor Kenneth R. Simmonds*
- J. Norton & P. Sargent (eds.) *Finance and Financing in Latin America*
- J. Olson *Bank Insolvency: International and Comparative Dimensions*
- T. Wan *Banking Law Reform in Taiwan and the Chinese Economic Circle*

C. Kluwer International Banking and Finance Law Series
(Prof. J. Norton - Series Editor)

- J. Norton (ed.) *Kluwer's Yearbook of International Financial Law* (1997)
- M. Andenas, L. Gormley, C. Hadjiemmanuil & I. Harden (eds.) *Institutional and Legal Aspects of EMU* (1997)
- J. Gold *Interpretation: The IMF and International Law* (1996)
- J. Norton *Devising International Bank Supervisory Standards* (1995)
- J. Norton, C. Cheng & I. Fletcher (eds.) *International Banking Operations and Practices: Current Developments* (1994)
- International Banking Regulation and Supervision: Change and Transformation in the 1990s* (1994)

Other Titles Commissioned:

- J. Gold *IMF and International Monetary Law*
- P. Taylor *Contracting for Corporate Debt*
- C. Olive *Derivative Instruments*
- J. Norton (ed.) *IOSCO: A Critical Evaluation*
 C. Hadjiemmanuil (ed.) *EMU: Private Transactions and Payment Systems*
- M. Steinberg *International Securities Regulation*

D. Sweet & Maxwell Law and Practice of International Finance Series
 (P. Wood - Series Author)

- P. Wood *Comparative Financial Law* (1995)
- Principles of International Insolvency* (1995)
- Comparative Law of Security and Guarantees* (1995)
- International Loans, Bonds and Securities Regulation* (1995)
- Project Finance, Subordinated Debt and State Loans* (1995)
- Title Finance, Derivatives, Securitisations, Set-off and Netting* (1995)

E. Matthew Bender International Finance Series
 (J. Norton - Series Editor)

- J. Norton (ed.) *International Tax Planning After the Tax Reform Act of 1986* (1987)
- Prospects for International Lending and Reschedulings* (1988)
- European Economic Community: Trade and Investment* (1986)
- World Trade and Trade Finance* (1985)

F. Publications on US Banking and Finance Law

- J. Norton & S. Whitley *Banking Law Manual* (1983-1995)
- J. Norton, T. Gillespie & D. Rice (eds.) *Commercial Finance Guide* (1990-1995)
- J. Norton & M. Baggett (eds.) *Lender Liability: Law and Litigation* (1989-1995)
- J. Norton & T. Conner (eds.) *Commercial Loan Documentation Guide* (1988-1995)
- J. Norton, et al. (eds.) *Commentaries on the "Restatement (Third) on the Foreign Relations Law of the Institueed States"* (1992)

- J. Norton (ed.) *Understanding Bankruptcy in the US: An International Handbook of Law and Practice* (1992)
- J. Norton (ed.) *Representing Debtors in Bankruptcy - Practice Strategies* (1991)
- J. Norton, *et al.* (eds.) *Strategies and Litigation Considerations in Chapter 11 Bankruptcy* (1988)
- J. Norton, *et al.* (eds.) *Fundamentals of Chapter 11 Reorganization* (1987)
- J. Norton *Commercial Business and Trade Laws - U.S.A.* (1984-1985)
- J. Norton *Regulation of Business Enterprises in the U.S.A.* (1983-1984)

G. Other Institute Related Book Publications

- R. Lastra *Central Banking and Banking Regulation* (1996)
- J. Bello, A. Holmer & Norton (eds.) *The North American Free Trade Agreement: A New Frontier in J. International Trade and Investment in the Americas* (1994)
- J. Norton & R. Auerback (eds.) *International Finance in the 1990s: Challenges and Opportunities* (1993)
- J. Norton & P. Spellman (eds.) *Asset Securitization: International Financial and Legal Perspectives* (1991)
- J. Norton (ed.) *Doing Business in Mexico* (1988-1991)
- W. Ebke & J. Norton (eds.) *Festschrift in Honor of Sir Joseph Gold* (1990)
- A. Hermann (1990) *Economic and Legal Problems of Transition to Market Economy*
- R. Cranston (ed.) *Legal Implications of Cross Border Banking* (1989)
- R. Goode *Legal Problems of Credit and Security - 2nd Edition* (1988)
- R. Goode (ed.) *Group Trading and the Lending Banker* (1988)
- J. Norton (ed.) *Public International Law and the Future World Order: Liber Amicorum in honor of A.J. Thomas, Jr.* (1987)
- R. Pennington *Bank Finance for Companies* (1987)
- R. Goode (ed.) *Conflicts of Interest in a Changing Financial World* (1986)
- R. Goode (ed.) *Electronic Banking: The Legal Implications* (1985)
- R. Goode *Payment Obligations in Commercial and Financial Transactions* (1983)

Professor P. Wood and Mr. W. Blair, QC, are also part-authors of the multi-volume *Encyclopedia of Banking Law*.

PUBLICATIONS: Institute Publication Vehicles

One of the special features of the Institute is its significant access (directly or through various Institute members) to major book publications and journals. This feature opens up publication opportunities for those conducting research at, through or in conjunction with the Institute/CCLS. Of particular note, members of the Institute have direct involvement in the following publications:

- ❖ Lloyd's of London Press - Banking Law Series
- ❖ Sweet & Maxwell - Law and Practice of International Finance Series
- ❖ Kluwer International Banking and Finance Series
- ❖ Kluwer International Economic Development Law Series
- ❖ NAFTA: Law and Business Review of the Americas (quarterly)
- ❖ Butterworth's Journal of International Banking and Finance Law
- ❖ Kluwer's Yearbook on International Financial Law
- ❖ Kluwer's Yearbook on International Economic Development Law.

In addition, members of the Institute maintain close working relationships with the following publications:

- ❖ *The International Lawyer* (quarterly) (US)
- ❖ *Journal of Business Law* (quarterly) (UK)
- ❖ *Banking and Finance Law Review* (quarterly) (Canada)
- ❖ *Securities Regulation Law Journal* (US)
- ❖ *Law in Transition* (quarterly) (EBRD)

Further, the Institute, in conjunction with the London Institute of International Banking, Finance and Development Law, maintains a **Studies in International Financial and Economic Law** series.

ONGOING SPECIAL RESEARCH PROJECTS

The Institute is currently engaged, jointly with the CCLS, in a series of major research/publication projects:

IOSCO The Institute is engaged in an ongoing academic related research project with the Secretariat of the International Organisation of Securities Commissions (IOSCO), headquartered in Montreal, to provide academic backup analysis and perspectives to the efforts of Working Group No. 2 (on OTC derivatives) and No. 3 (on Prudential Supervision) of the IOSCO Emerging Markets Committee. These co-operative efforts may result in several research seminars (involving leading experts drawn

world-wide) and related major publications. As well, the Institute is preparing a more general (but thematic and critical) evaluation of the role and functions of the IOSCO organisation.

EBRD From time to time, the Institute engages in joint academic-related research seminars and projects of mutual interest with the Office of the General Counsel (OGC) of the European Bank for Reconstruction and Development (EBRD), which is headquartered in London. For example, the Institute and EBRD's OGC have co-operated in annual research seminars (involving leading experts drawn world-wide) on the role of international financial transactions in emerging economies and on secured financing arrangements in emerging economies - each of which has produced a book publication and several published research papers and articles. A future research seminar and related book publication is planned on bank insolvencies in emerging economies, in which members of the EBRD's OGC and the Legal Dept of the IMF will be actively involved.

In addition, a member of the Institute's research staff assists in the editing of, and solicitation of law reform articles for, the OGC's publication, *Law in Transition*. Members of the Institute have prepared an extended Working Paper on Central and Eastern European Capital Market and Stock Exchange Regulation for the OGC. Also, parties associated with the Institute have been asked to provide advisory assistance on the OGC's ongoing efforts in the corporate governance area; and one Institute Research Fellow is pursuing doctoral studies on EBRD related matters. The former and first EBRD General Counsel serves as a Senior Visiting Fellow for the Institute and as a member of the CCLS's Advisory Council.

EMU Single Currency/FLP/CEL The Institute is engaged, on an ongoing basis, in monitoring and evaluating the public and private law implications of the European Monetary Union (EMU) and its move to a single European Currency. The Institute is conducting part of its EMU efforts in collaboration with the London Financial Law Panel (FLP) (established under the auspices of the Bank of England and supported by the Bank and the major London financial institutions and law firms). One aspect of these FLP-related activities comprises a world-wide survey and evaluation on the external legal impact of the Single Currency.

In addition, the Institute, along with the Centre of European Law (CEL) at King's College London, conducts periodic research seminars (involving leading European and overseas experts) on EMU. Two of these seminars have produced two major book publications on the institutional and private law dimensions of the Single Currency, in addition to several scholarly articles and research papers. The FLP and various of the European authorities (including Commission Directorates, the European Investment Bank and the Legal Department of the European Monetary Institute) have supported or otherwise participated in these efforts.

ONGOING REGIONAL INVOLVEMENTS

The Institute is currently especially focused on a number of regions throughout the world:

Central and Eastern Europe The Centre/Institute have been actively involved with law reform and related projects in the Central and Eastern Europe (CEE) region since the late 1980's. Individuals associated with the Institute have engaged directly in major financial law reform in the financial and fiscal areas (e.g., Poland, Hungary) and have provided advice and training to governmental officials on financial and fiscal law reform in a number of other CEE countries (e.g. Bulgaria, Czechoslovakia, Kyrgystan, Latvia, Lithuania, Romania, Russia and Ukraine).

In terms of its academic programmes, the Institute is involved with teaching the LL.M "Wider Europe" and "Emerging Markets" courses (each of which give consideration to legal issues related to the CEE), and each year provide six month education courses for 20-30 experienced attorneys, academics and government officials from the CEE under the UK Central Europe Lawyers Scheme.

Moreover, in any given year, there are several doctoral students and Visiting Scholars pursuing research respecting CEE issues. The Institute also conducts, from time to time, special training courses for lawyers and bankers from CEE countries.

The Institute also pursues its CEE efforts through its cooperation with the European Bank for Reconstruction and Development (see above).

Chinese Economic Area (CEA) and South East Asia (SEA) The Institute has identified the South East Asia areas as an ongoing major area for research and special external activities. At any one time, the Institute generally has from 6-8 full-time researchers in residence on various financial law-related topics involving South East Asian countries.

The problems of convergence of financial laws (*i.e.* banking, insurance and securities) within the CEA (*i.e.* PRC proper, Hong Kong and Taiwan) is a particular research focus for the Institute. The Institute recently has held one major conference in Taipei, which produced two scholarly books and several articles and is planning an upcoming research seminar in London (which also should produce a book publication) and a banking law conference in Beijing. A member of the Institute also serves as the Chief Law Examiner for the University of Hong Kong. By the end of 1998, the Institute expects to have published at least six volumes covering CEA related-topics.

Other SEA countries of current Institute active research focus include Japan, Korea and Thailand.

The Western Hemisphere (US and Latin America) The Institute maintains major expertise concerning Instituted States financial law. Not only does the Sir John Lubbock Professor hold a dual professorial appointment in financial institutions law in the US, but the Institute engages (on a regular basis) six Visiting Professorial/Senior Fellows from the US and has in residence at least two full-time US researchers. Leading American scholars and government officials are also periodic visitors to the Institute, to its courses and research seminars. Professor Norton and two regular research assistants maintain ongoing research into banking law developments.

The Institute maintains active research, publication and conference links with the SMU NAFTA Law Centre in Dallas, Texas, and with the Graduate Banking Law Programme in Buenos Aires, Argentina.

Southern Africa The Institute actively co-operates, on an on-going basis, with the South African government funded Banking Law Institute in Johannesburg, and on research and related publications on the development of and fostering of the understanding of banking and financial law throughout the Southern African Region. In this context, a member of the Institute serves as the government assessor of the Johannesburg Banking Law Institute and as Vice-President of the Association of Southern African Banking Lawyers.

RESEARCH SEMINARS, CONFERENCES AND TRAINING:

Research Seminars

The Institute strives to produce research seminars on a semi-annual basis in areas of specific interest and expertise in an effort to disseminate and encourage research and publication on an international basis. Recent research seminars, jointly sponsored with the CCLS, have included:

Emerging Financial Markets and the Role of International Institutions (May 1995)

(with the Office of the General Counsel, EBRD; Centre of European Law, KCL; and SMU School of Law)

Emerging Financial Markets and the Role of Secured Transactions (October 1995)

(with the Office of the General Counsel, EBRD; Centre of European Law, KCL; and SMU School of Law)

Workshop on Institutional Aspects of EMU (January 1996)
(with Centre of European Law, KCL; and in co-operation with the Faculties of Law of the Universities of Groningen and Sheffield, and the Institute of Advanced Legal Studies)

Private Law Aspects of EMU (October 1996)
(with the support of the European Investment Bank, the Financial Law Panel (London), the Centre of European Law, KCL, and the Institut Européennes, Université Libre de Bruxelles)

GATS and Banking Supervision (May 1997) (with Centre of European Law KCL)

Financial Supervision in the Chinese Economic Area (June 1997)

IOSCO and Emerging Financial Markets (Autumn 1997) (with IOSCO)

Bank Insolvency (October 1997) (with EBRD & IMF)

RESEARCH SEMINARS, CONFERENCES AND TRAINING:

Joint Annual Conferences

The Institute actively supports and participates in a number of high level annual conference in conjunction with the following Institutions:

- ❖ University of Buenos Aires, Argentina
- ❖ SMU School of Law, NAFTA Law Centre, Dallas, Texas
- ❖ University of Beijing
- ❖ Rand Afrikaans University, South Africa

RESEARCH SEMINARS, CONFERENCES AND TRAINING:

Professional Conferences/ Seminars

The Institute, in conjunction with the CCLS and the London Centre for International Banking, organises and presents a number of specialist conferences/seminars for bankers, lawyers and financial executives focusing of topical areas of special expertise within the Institute.

Annual Professional conferences/seminars include:

- ❖ **English Banking Law**
- ❖ **Banks: Fraud & Crime** (or other specialised Banking Topic)
- ❖ **International Banking and Finance Summerschool**

RESEARCH SEMINARS, CONFERENCES AND TRAINING:

Governmental and Professional Training (Emerging Markets)

In addition to training of lawyers from many emerging and transitioning countries through various conferences/seminars, members of the Institute have been extensively involved in training programmes in emerging markets world-wide involving local government officials, lawyers and executives. Training sponsors have included the International Development Law Institute (IDLI), the British Know-How Fund, the European Commission's Phare Programme, and the Southern African Banking Law Institute. Training programmes have involved lawyers, bankers and government officials from regions including Central and Eastern Europe, the Former Soviet Union, Asia, and

Southern Africa. An annual training programme for lawyers and bankers in the People's Republic of China is currently being planned.

SUMMARY OF EDUCATIONAL INSTITUTIONAL NETWORK

The Institute (and various of its members) in conjunction with the CCLS, maintain close working relationships with the following educational organisations:

- ❖ Graduate Banking Programme, University of Buenos Aires, Argentina
- ❖ Centre of European Law, King's College, London
- ❖ Institute of European Finance, University College of North Wales, Bangor
- ❖ Max Planck Institute for Private International Law, Hamburg
- ❖ Cologne Banking Institute, University of Cologne, Germany
- ❖ Banking Law Institute, Rand Afrikaans University, South Africa
- ❖ SMU Institute of International Finance, Dallas, Texas
- ❖ SMU NAFTA Law Centre, Dallas, Texas
- ❖ Morin Banking Law Center, Boston University School of Law
- ❖ Muenster International Business Law Institute, University of Muenster
- ❖ Institute of International Business Law, University of Konstanz, Germany
- ❖ Faculty of Law, University of Lund
- ❖ Faculty of Law, University of Hong Kong
- ❖ Soochow University Graduate Law School, Taipei, Taiwan
- ❖ Osgoode Hall Law School, York University, Toronto, Canada
- ❖ William & Mary School of Law, Williamsburg, Virginia
- ❖ Central European University, Budapest
- ❖ New York University School of Law
- ❖ School of Finance and Accounting, University of Southampton
- ❖ Fletcher School of Law and Diplomacy, Tufts University, Boston
- ❖ Faculty of Law, University of Stockholm
- ❖ Centre for Law Reform Studies, London

ASSOCIATED INSTITUTIONS

Centre for Commercial Law Studies, Queen Mary & Westfield College, University of London

The Centre for Commercial Law Studies is the focal point in the United Kingdom for advanced teaching and research in commercial law, a field in which it enjoys an international reputation. The primary objectives of the Centre are to promote, through advanced teaching and research, the systematic study of national and international commercial law and to develop a body of knowledge and information that can be placed at the service of government, the legal profession, industry and commerce.

The CCLS is composed of four independent Units, each with its own individual areas of expertise, courses, faculty and interests:

European Commercial Law Unit
International Financial Law Unit
Information Technology Law Unit
Intellectual Property Law Unit

The Centre is especially well placed for these activities, situated as it is in close proximity to the City of London, one of the world's leading financial centres, with ready access to a wide range of specialist institutions and practitioners. The Centre serves as a forum for the testing of new ideas and the exchange of information, views and expertise among academics, practitioners and those engaged in finance, commerce and industry. One of the Centre's most prominent international initiatives is the UKCELS programme, in conjunction with the Foreign & Commonwealth Office and leading law firms, which brings young Eastern European lawyers to the UK for commercial law study and placements in law firms.

The Centre is the only organisation in the United Kingdom devoted exclusively to the advanced teaching and study of commercial law, and offers more than thirty law courses in the University of London's Intercollegiate LL.M. programme.

International Financial Law Unit, CCLS, OMW, London

The International Financial Law Unit (IFL Unit) is one of four internationally renowned postgraduate research and teaching units of the Centre for Commercial Law Studies (CCLS), *Queen Mary and Westfield College* (Queen Mary), *University of London*. In the 1996 HFKE Research Assessment Exercise, Queen Mary and Westfield College received a rating of 4 in the area of law, based on 35.8 Category A Research Active Staff (FTE). The Unit's primary objectives are: *excellence* in postgraduate law teaching, *excellence* in scholarly research and publications and *excellence* in its external activities.

The Unit is composed of the Sir John Lubbock Professor of Banking Law at the University of London (Prof. J. Norton), a permanent Visiting Professor of International Finance Law (Prof. P. Wood), three Lecturers (Dr Rosa Lastra, Lecturer in International Financial and Monetary Law; Dr George Walker, Lecturer in UK and European Banking Law; and Ms Anna Mörner, Lecturer in Financial Law), one Fellow (Mr Douglas Arner, Sir John Lubbock Support Fund Fellow in International Capital Markets Law), and two Research Assistants (Ms Heba Shams and Ms Mamiko Yokoi). In addition, the Unit is supported by a group of over 30 Fellows (comprised of leading UK, European Union and US experts) and a Board of International Scholars (BIS) of approximately 50 distinguished members drawn worldwide.

The Unit conducts its activities as a *Postgraduate Teaching and Research Institute*, emphasising UK, EU, international and comparative banking, financial and tax law issues and banking, finance, and

issues pertaining to developing, emerging and transitioning economies. The Unit and its members are engaged in numerous research, publication, consultation, law reform and conference activities on a worldwide basis.

In general terms, the Unit operates along the lines of three components: a **banking** component, a **finance** component, and an **emerging markets** component. However, a unique dimension of these groupings is that they often function in an **integrated** manner. For example, emerging markets studies comprise development law, banking and finance law.

European Commercial Law Unit, CCLS, OMW, London

The European Commercial Law Unit emphasizes the great significance of the European and international dimensions of commercial law. While special attention is paid to relevant aspects of the law and policies of the European Union, the importance of the wider European, and of the fully international context of many commercial law subjects is equally embraced. The special value of comparative study of commercial law is also reflected in much of the Unit's activity. It is under the direction of the Director of the Centre. Other members of the Unit are Marise Cremona (Senior Fellow), Dr Julian Lew (Visiting Professorial Fellow and Head of the School of International Arbitration), Ron Harmer (Robson Rhodes Senior Research Fellow in International Insolvency Law), and a number of distinguished Visiting Fellows. The Unit offers LLM courses and half-courses in The European Internal Market; EC External Legal Relations; European Community Company Law; European Community Commercial Law and the Wider Europe; EC Competition Law; Commercial Conflict of Laws; International Business Transactions; International Trade Law; the Law of Insurance; Marine Insurance; and Comparative US and EC Antitrust Law.

The Unit also makes a substantial contribution to the Centre's commitment to international education by running the Texas exchange programme (accredited by the American Bar Association) and by close involvement in the organisation of the UKCELS scheme and other training programmes for lawyers from Central and Eastern Europe and the former Soviet Union. The Commercial Law lectures and other related seminars are also organised within the Unit.

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