

**REPORT OF THE  
SES REVIEW COMMITTEE**

29 JULY 1998

# CONTENTS

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## **PART ONE**

### **▪ TERMS OF REFERENCE**

## **PART TWO**

### **▪ OVERVIEW**

1. General Observations .....	2
2. Review Framework .....	2-3
3. Summary .....	3-5
4. Conclusion .....	5

## **PART THREE**

### **▪ RECOMMENDATIONS**

1. Competition .....	6-8
2. Regulatory Environment .....	8-9
3. Scope of Activities .....	9-11

## **PART FOUR**

### **▪ COMPETITION - MEMBERSHIP AND COMMISSION**

1. Introduction .....	12
2. The Structure of Competition - Local Stockbroking Companies .....	12-13
3. The Structure of Competition - Foreign Participation in the Securities Industry .....	13-15
4. Issue of New Seats .....	15-16
5. Commission Rates .....	16-17
6. Commission Rates - Recommendations .....	17-20
7. Conclusion .....	20

## **PART FIVE**

### **▪ REGULATORY ENVIRONMENT - OPERATIONS OF MEMBER COMPANIES, RULES AND REGULATIONS**

1. Introduction .....	21
2. SES Internal Guidelines .....	21
3. Trust Account Requirements .....	21
4. Computation of ANC .....	22
5. Limit on AI .....	22
6. Maintenance of Reserve Fund .....	22-23
7. Margin Account .....	23
8. List of Recognised Stock Exchanges .....	24
9. Settlement Period .....	24
10. Provisions in Annual Accounts .....	24
11. Others .....	24

## **PART SIX**

### **▪ SCOPE OF ACTIVITIES - NEW PRODUCTS AND SERVICES**

1.	Introduction .....	25-26
2.	Fund Management Activities .....	26
3.	Self Regulatory Environment .....	26-27
4.	Development of New Products .....	27-29
5.	Development of Infrastructure for Trading the Debt Market by SES Members .....	29-30
6.	Single Operating Systems to Book Trades .....	30-31
7.	Formation of a Tax/Regulatory Issues Working Group .....	31
8.	Other Recommendations .....	31

## **PART SEVEN**

### **▪ ACKNOWLEDGEMENTS**

## **PART EIGHT**

### **▪ APPENDIX**

1.	Categories of Brokers in Singapore
2.	Market Turnover (Jan 96 - Dec 97)
3.	Brokerage Rates and Market Turnover
4.	Summary of Analysis
5.	Recommendations on Competition
6.	Recommendations on the Regulatory Environment
7.	Licensing Requirements
8.	Development of a Securities Borrowing and Lending Program in Singapore
9.	Regulated Short Selling
10.	Development of Listed Property Trusts in Singapore
11.	Development of a Multi-Currency Multi-Asset Management Account

## TERMS OF REFERENCE

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The SES Review Committee (SESRC) was formed by the Financial Sector Review Group chaired by Deputy Prime Minister, BG (NS) Lee Hsien Loong. The SESRC is to make recommendations on the development of our Singapore capital markets bearing in mind:

- the objective of further developing the Singapore capital market, to make Singapore a key financial centre;
  - the need to provide greater scope for business initiative and innovation in the securities market, while maintaining the soundness and integrity of the financial system; and
  - the principles outlined by the Government, including:
    - maintaining high standards of integrity and sound financial management;
    - shifting the emphasis in approach from regulation to supervision;
    - focussing more attention on systemic risk, rather than protecting individual participants, products, or projects;
    - providing greater transparency in regulations;
    - allowing investors to judge and take business risks for themselves; and
    - relying more on market discipline and full information disclosure to protect investors
- a To consider regulatory and structural options and recommend a conceptual framework that will make our capital markets more international, competitive and robust, able to participate fully in the dynamic global network of capital markets. This includes liberalising market access and commission rates for transactions.
- b To review the regulations, by-laws, administrative notices and other prudential & regulatory approaches of the Stock Exchange of Singapore (SES). This includes the Securities Industry Act and the Securities Industry Regulations, as well as SES Rules & By-laws.
- c To recommend industry development initiatives by government, SES and member firms e.g. upgrading skills in the industry, and expanding the scope and range of products and services.

## OVERVIEW

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### 1 General Observations

Basic observations were made in the course of this review:

The size of our Singapore economy can be limiting factor on the size of our securities market. We have a small domestic client base. There is however a very large market out there.

Comparative data on market performance measured in terms of market capitalization, turnover and product innovation over the last ten years shows clearly that our market has not kept pace with international developments.

Markets are becoming borderless. The movement to a world where capital markets operate without regard to national boundaries is in process. In the developed world, the foreign exchange and bond markets are most advanced in this globalization process. Equity markets will follow.

The drive towards globalization is aided by technology (computers and telecommunications) and financial innovations (derivatives and structuring techniques). Arbitrage will resolve market anomalies and market inefficiencies.

Market participants whether as banks, insurance companies, fund managers and stockbroking companies are strategically repositioning themselves worldwide through acquisitions, mergers and divestments. Market forces will unleash these fusion and fission processes.

Even exchanges are resorting to mergers and acquisitions to provide seamless access to multiple markets. We witness the consolidation of stock exchanges within national boundaries. The merger of the London and Frankfurt stock exchanges attest to a new trend in cross border integration of the capital markets.

### 2 Review Framework

It is in the appreciation of these trends that the SESRC is to recommend a framework that will make our capital markets more international, competitive and robust. To complement the work of the Financial Sector Review Group, our committee has decided on the bottom-up approach by looking at issues from our securities industry perspective. Various sub-committees were formed to address the immediate issues at hand. These issues formed the main framework of our report:

Competition	–	Membership and Commission
Regulatory Environment	–	Operations of Member Companies, Rules and Regulations
Scope of Activities	–	New Products and Services

The object of this review is to increase competition within the securities industry, improve the regulatory environment and enlarge the scope of activities of market participants. This

is in recognition that the success of past policies cannot be extrapolated into the future. Organisations would have to change with the evolution of the marketplace. If change is not done, obsolescence will set in.

The liberalization of brokerage rates will have a tremendous impact on SES member companies. The traditional sources of revenue will decline. New revenue streams would have to be found. It is therefore fundamental that our regulatory framework is in place to allow member companies to restructure and enlarge their scope of activities.

The domestic market is small and potentially limited. Given our population base and the small size of our economy, it is not a significant attraction to global financial institutions. It is the large market out there that we should focus our energies.

The competitive advantage Singapore has is its stable and forward looking government, excellent infrastructure, a wide network of financial institutions with the professional expertise, transparent regulatory environment and more importantly, the willingness to enforce its rules and regulations to ensure a fair and orderly market.

Singapore is in a unique time zone where it can complement the markets of New York and London. The potential of the market out there as with the Asian dollar market and the foreign exchange market would draw many global institutions. The Asian dollar market has made us a dominant offshore banking centre in Asia. We have the fourth largest foreign exchange market in the world. The regional economies and regional companies can find Singapore an attractive marketplace for raising capital. The recent listing of non-Singapore dollar stocks in SES attests to its potentialities. It is this scent of the market out there that underpins our review. The globalization of the equities market will add impetus to this creation.

### **3 Summary**

Listed below is a summary of views within the review framework.

#### Membership

There should be wider participation in the industry promoting a more liberal approach towards ownership and management renewal. The opening of the securities market to increase international participation will broaden the scale and scope of the industry. The SESRC also views that the nurture of a vibrant indigenous participation as important for longer term societal goals. As a consequence, the SESRC advocates an expansion of international memberships and for the liberal ownership transfer of local memberships. Quality control will be focused on management.

Recent changes in major overseas exchanges particularly in the area of demutualization suggest the need for appraising the merits of separating ownership from membership participation of the Stock Exchange. This study goes beyond the scope of the present committee. It would be within the purview of the McKinsey-MAS review to consider a competitive structure for the securities industry. The governance structure of SES would affect our recommendations relating to local and foreign participation of member companies.

#### Commission Rates

To move towards a more efficient market, the cost of transaction must be minimised. Liquidity, brokerage, tax and the bid and offer spreads are joint determinants of transaction cost. The liquidity of a stock is its ability to transact volume with minimal changes in price. Stamp duty and GST can be abolished. The freeing of brokerage will initially have an adverse impact on member companies' viability. Adequate time must be allowed for market

participants to rationalize, reposition or sell out. As a consequence, the freeing of brokerage should be done in phases.

### Regulatory Environment

There is no doubt that our industry is fashioned on the Anglo-Saxon mould and it is with this heritage that our worldview is cast. The promotion of transparency, disclosure and higher private sector initiative and the reliance on market discipline are cornerstone principles of an efficient and effective market system. The SESRC has applied these principles to review all aspects of the operation of securities firms, including capital and other financial requirements, rules and regulations governing their activities. There is no way we can protect member companies from business failure but we can design our regulatory environment to avoid systemic risk.

In view of growing regionalisation, the SESRC advocates the setting up of trust accounts in reputable overseas banks in foreign currencies and an expansion of the list of recognised regional exchanges. Member companies are also given the discretion of the securities, including foreign securities, they want to finance subject to certain safeguards. There is also more flexibility in the utilisation of capital through Adjusted Net Capital computation and the limit on Aggregate Indebtedness.

### Scope of Activities

The SESRC calls for a more liberal attitude towards the scope of activities which market participants can undertake in the securities industry. The scope of activities need to be expanded even at the risk of overlap to allow for a more vibrant industry. Current regulatory typology of financial activities tend to “box-in” the operations of member companies. Given the convergence of financial services, the existing licensing framework would have to be reset. We view that it is a natural progression for stockbroking companies to expand into investment portfolio management and corporate finance. The American concept of moving stockbroking into investment banking requires a paradigm shift in regulatory structure and mind set. However with the existing licensing framework, we advocate that facilitation be promoted for SES member companies to have full investment advisors’ licenses (IA) if they so wish to apply.

The U.S. regulatory structure was developed essentially in the 1930s. Then, a “futures contract” meant risk instruments with respect to agricultural products and “securities” primarily meant stocks and bonds. In the last 2 decades, however, the futures industry evolved into a financial services industry, while the securities industry became involved with derivative financial products. In short, the increasing convergence makes distinction between the definition of a security and futures contract increasingly difficult. Having a regulatory system that has not kept pace with the products it regulates hampers creativity and development. The definition of “security” in our Securities Industry Act can be expanded to include futures.

There should be a pro-development environment for the cultivation of new financial products. Development can be opportunistic given windows where there are market inefficiencies. A wide variety of new investment and risk hedging products would encourage more foreign financial players to establish a presence in Singapore. Many of these products such as securities borrowing and lending and real estate investment trust hinge on the resolution of tax and regulatory issues. The SESRC advocates the formation of a working group comprising IRAS, MAS, SES and financial participants to institutionalize this cultivation process.

## **4 Conclusion**

The road ahead will not be easy in particular for member companies. There has to be rationalisation and restructuring. Market participants have to take into consideration the structural convergence of the finance industry whether as banks, insurance companies, securities firms or fund managers.

Technology is a major driving force in this process of globalisation. The benefits of globalisation and free markets cannot be denied. Arbitrage and competition will ensure the optimisation of prices. Technology makes possible the simultaneous display of prices and information in different locations. Competition will not always be confined within national boundaries. The integration of global capital markets is made possible through electronic trading and processing systems. Exchanges are consolidating through domestic mergers and the formation of cross border alliances. Such monumental changes would demand a paradigm shift in mindset among industry players.



## RECOMMENDATIONS

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Taking cognizance of the macro trends at large, our Committee adopts the approach from our securities industry perspective to make recommendations.

### COMPETITION

#### Membership

##### *Recommendation 1*

- Current restrictions on local ownership of SES members to be removed. All financially sound local entities should be allowed to buy stakes of any size in local member companies. SES would retain the right to reject substantial stakes if there are grounds to believe that the proposed participants are of unsound character or financial standing. SES will continue to regulate the approval of the persons appointed to manage the businesses.

##### *Recommendation 2*

- Securities professionals dealing in SES-listed and/or quoted securities to be required to pass the Dealer's Representative's (DR) examinations. Securities professionals dealing solely in non-SES listed and/or quoted securities should either possess a DR licence or possess an appropriate professional qualification to deal in those securities.

##### *Recommendation 3*

- No additional Approved Foreign Brokers (AFBs) to be admitted and existing AFBs to be encouraged to seek International Member (IM) status.

##### *Recommendation 4*

- In the longer term, the remaining restrictions on IMs and the cap on foreign ownership of full members could be removed. The industry has at most 5 years to complete this change. However, the means by which foreign firms participate on the Exchange will depend on a review of the structures of governance for the SES. In the light of recent changes in major overseas exchanges, the merits of separating ownership of the SES from participation as a member, e.g. through demutualisation, need to be studied. The SESRC understands that this will be done under the ambit of the McKinsey-MAS review.

##### *Recommendation 5*

- Until governance issues are settled, it is recommended that a consistent policy be applied to foreign participation in member firms. The ownership limit for new or existing joint ventures should be standardised at 70%. Foreign securities firms which require 100% ownership should be allowed to buy out local partners but would, during this interim period, have to operate under IM rules rather than as full members. Conversely, existing IMs which wish to broaden their activities to the retail arena should be allowed to convert to full membership as long as they sell 30% to a local entity.

##### *Recommendation 6*

- IMs to be allowed to trade freely with any foreign clients and SES-approved local financial institutions.

#### *Recommendation 7*

- IMs to be allowed to stand for election as SES Committee members and vote on election of SES Committee members. However, at least half of the elected SES Committee members should be representatives of majority local firms to ensure that interests of retail investors are not overlooked since IMs do not have a remisier base.

#### *Recommendation 8*

- The sale of all new memberships should be deferred at least until 1 January 2000 to allow time for industry consolidation, in so far as the current ownership structure of SES remains.

#### *Recommendation 9*

In the event that the current governance structure is retained, new IM seats can be sold by tender to prequalified firms based in part of their ability to participate in the development of new product and service areas, with a minimum floor price set for the tender. This floor price should take into account the value of the SES' assets. One proposal suggests that the floor price should be no lower than the last successful bid for an IM seat. If however, the authorities wish to reduce the entry price, a separation of competitively-priced trading rights from the ownership of shares in the SES could be considered. Decisions on these issues hinge on the conclusions of the McKinsey-MAS study on SES governance.

### **Commission**

#### *Recommendation 10*

- Amalgamation of trades be allowed for all approved fund managers with immediate effect.

#### *Recommendation 11*

- Life insurance companies, finance companies and fund management companies which are exempt Investment Advisers (IAs) under Regulation 41(1)(e) of the Securities Industry Regulations are to be eligible for rebate of 25% of brokerage with immediate effect.

#### *Recommendation 12*

- From 1 January 1999, to give impetus to brokerage liberalization, it is recommended that minimum commission rates be reduced by 5% for all transactions for the period from 1 January 1999 to 31 December 1999.

#### *Recommendation 13*

- From 1 January 1999, minimum commission per contract to be raised from \$2 to \$10.

#### *Recommendation 14*

- From 1 January 1999, commission for pure fixed income securities and non-Singapore dollar denominated securities to be fully negotiable.

#### *Recommendation 15*

- From 1 January 2000, all rebates to be eliminated.

#### *Recommendation 16*

- From 1 January 2000, commission rates be revised as follows:-

Trades  $\leq$  \$150,000, Minimum of 0.75%  
Trades  $>$  \$150,000, Fully negotiable

*Recommendation 17*

- From 1 January 2000, commission for all approved fund manager trades to be fully negotiable.

*Recommendation 18*

- From 1 January 2000, stamp duties and GST for securities transactions to be eliminated.

*Recommendation 19*

- By 1 January 2003, commission for all trades to be fully negotiable.

## **REGULATORY ENVIRONMENT**

*Recommendation 20*

- SES should minimise the use of administrative discretion. Any policy or requirements to be imposed on member companies should be set out in practice notes and issued to all member firms.

*Recommendation 21*

- The trust account provision should be amended to allow clients' monies in foreign currencies to be held in overseas banks, provided that the prior consent of the client is obtained.

*Recommendation 22*

- The rules on computation of Adjusted Net Capital (ANC) should be modified to allow DR monies retained by a stockbroking company to be offset against clients' contra losses. In addition, the haircuts for outstanding contracts should be based on "market day" instead of "calendar day".

*Recommendation 23*

- The limit on the Aggregate Indebtedness (AI) of member firms should be raised.

*Recommendation 24*

- The requirement that SES member firms maintain a reserve fund which is not available for distribution as dividends should be modified to take into account factors such as the shareholders' funds and net cash position of member firms.

*Recommendation 25*

- The rules on margin account should be relaxed to allow SES member companies the discretion to decide on the securities they want to finance, subject to certain safeguards. In addition, cash and securities deposited by a client as collateral and securities bought under the client's margin account and amount owed by the client under margin account should be fungible.

*Recommendation 26*

- The list of Recognised Stock Exchanges should be expanded to include other regional stock exchanges such as the Jakarta Stock Exchange, Philippines Stock Exchange, Shenzhen Stock Exchange, Shanghai Stock Exchange and Mumbai Stock Exchange.

*Recommendation 27*

- The period for settlement of share transactions should be reduced from T+5 to T+3.

*Recommendation 28*

- Tax deduction for member firms' provision for contingency and general provision (similar to those permitted for banks for their provisions for bad and doubtful debts) should be allowed.

*Recommendation 29*

- Others
  - Prior to amending its Bye-Laws or issue of any practice notes, SES should consult member firms for feedback;
  - A quarterly forum or workshop should be conducted to allow SES and member firms to discuss problems/difficulties faced;
  - The underlying reason for imposing any operational directive or administrative sanction against a member firm should be specified clearly to the affected member firm;
  - As in the case of DRs, all mid-office or back-office personnel (of officer level) of member firms should be required to attend compulsory courses;
  - Consideration could be given to allow DRs clerks to have their own terminals but with the same identity number as their principals; and
  - DRs should be permitted to have an interest in stockbroking companies (other than the one to which the DR is attached as agent or employee), provided that such interest does not exceed 5% of the issued capital of the company and is confined to SES member firms.

**SCOPE OF ACTIVITIES**

*Recommendations 30*

- The authorities should facilitate applications by SES members for an IA licence to act as investment advisers and financial planners. The criterion may be based on a lower capital requirement and other prerequisites such as research capabilities.

*Recommendation 31*

- Fund managers managing resident funds should be accorded the same tax benefits as those managing foreign funds. Being a development concept, these tax benefits should last for three years.

*Recommendation 32*

- Continuous education and qualifying examinations should be made mandatory for professionals of SES members who provide investment advice.

*Recommendation 33*

- Make it mandatory for fund managers to provide periodic and standard performance presentations to the public through accessible media sources.

*Recommendation 34*

- Encourage fund managers to insure themselves against professional negligence to adopt greater accountability.

*Recommendation 35*

- Authorities to sponsor a neutral arbitration board to resolve disputes arising from any dealings in securities.

*Recommendation 36*

- Develop a Securities Borrowing and Lending market and resolve any tax issues (including treatment of tax on SBL transactions and manufactured dividends) that are hindering its implementation.

*Recommendation 37*

- Authorities to monitor and provide more transparency to the rules governing short selling on the SES.

*Recommendation 38*

- Develop a SES stock index options product in S\$. SES or sponsoring member to develop country basket of shares of regional and global stock indices in US\$.

*Recommendation 39*

- Develop products similar to Listed Property Trusts (LPTs) and Real Estate Investment Trusts (REITs). However, to facilitate its development, the following issues have to be resolved :-
  - Authorities' view towards the taxation policy on LPTs/REITs. LPTs/REITs would receive a more favourable response if they are taxed at unitholders' level and not corporate level;
  - It is unclear whether unitholders of LPT/REIT (assuming of residential nature) who have made a purchase and sale transaction in the units within 3 years are subject to some form of capital gains tax similar to those applicable to investors who have made direct investments in residential properties; and
  - Since LPTs/REITs, like equity unit trust are launched without any previous track record, CPF rules would prohibit holders from using their CPF funds to invest in the LPT/REIT fund. This will substantially reduce the demand for LPT/REIT.

*Recommendation 40*

- Develop an electronic bulletin board and subsequently, an organised OTC market for foreign securities, including Korean, Indian global depository receipts and Asian convertible bonds.

*Recommendation 41*

- Broaden the scope of the SES options market by launching options on more securities, including CLOB Malaysian securities. Adopt more innovative derivative products.

*Recommendation 42*

- Develop infrastructure for trading of debt market by SES members. To facilitate its development, the following issues have to be considered :-
  - Government to issue long term bonds to facilitate the marking of a benchmark yield curve;
  - MAS to sponsor the establishment of a mortgage securities vehicle to encourage development of a national mortgage-backed securities market;
  - Encourage GLCs and financial institutions to issue high quality medium and long-dated bonds;
  - Selectively allow supranational and OECD countries to issue long term bonds in S\$ in Singapore;
  - SES to sponsor a recognised credit rating agency;
  - SES members to develop trading rules, requirement for dealer and capital/credit controls;
  - SES to implement a delivery versus payment system for debt transactions. The Clearing house should link with Cedel, Euroclear and other recognised clearing houses; and
  - Set up a working group with aim of developing a vibrant, competitive and efficient debt capital market.

*Recommendation 43*

- Stockbrokers to create a single operating system known as multi-currency, multi asset management account to enable trades of all financial products to be made through this account. The basic concept of this system is to account for investor's assets, be it cash or securities for the brokers to manage under one financial statement.

*Recommendation 44*

- Authorities to review existing regulation to allow stockbrokers to manage clients' cash or securities in one account (discretionary or non-discretionary).

*Recommendation 45*

- MAS, IRAS, SES and financial players to jointly form an on-going working group to study the impact of tax and regulatory issues on the development of any new financial products or services.

*Recommendation 46*

- Companies Act to be amended to allow companies to buy back stock and keep them as treasury stocks.

**COMPETITION**

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**1 INTRODUCTION**

- 1.1 This part deals with and makes proposals relating to the expansion of competition within the securities industry, both in terms of participants and the deregulation of commission rates.
- 1.2 The recommendations are made in the context of the need to make the SES more dynamic, robust and competitive. The SES Review Committee (*SESRC*) recognises the importance of opening the securities markets to increased international participation in order to broaden the scale and scope of the industry, but it also views vibrant indigenous participation as important for longer-term stability. In order to achieve these aims, the *SESRC* is proposing measures to expand foreign participation, reduce transaction charges, facilitate the development of new products and services, and bring about a revitalisation of the local securities industry.
- 1.3 The McKinsey-MAS review will be covering issues of regulatory structure for the securities industry. In the light of recent changes in major overseas exchanges, there is a need to study the merits of separating ownership of the SES from participation as a member, e.g. through demutualisation. This study goes beyond the scope of the present committee, but its conclusions could significantly affect the proposals in this report relating to participation by both local and foreign investors, and the issuance of new seats. In order to facilitate the process of change, the *SESRC* recommends that these issues should be expeditiously decided after a thorough study.

**2 THE STRUCTURE OF COMPETITION – LOCAL STOCKBROKING COMPANIES**

- 2.1 The policies of the SES in the past decade have not been conducive to ownership changes. More importantly, these policies have excessively linked ownership and management. Specifically, the SES has disallowed the purchase of more than 5% of the equity of stockbroking companies by local corporations which are not financial institutions; and by any individual with less than eight years of industry experience. Further, any person wishing to own more than 5% must become a stockbroking director, a rule which disallows that person from being involved in the management of any other business.
- 2.2 These policies have led to an aging of the industry's leading participants. Since the mid-1980s, capital requirements have risen significantly, so that it has become too onerous for industry professionals to buy meaningful stakes in securities firms. With the exception of family succession, there has been little meaningful evolution in the ownership of local stockbroking companies.
- 2.3 Meanwhile, the exclusion of non-financial institutions from the purchase of stakes in stockbroking firms (a policy enacted only in the past decade) has almost entirely prevented new local participation, given that all six commercial banks in Singapore already own stockbrokers. The *SESRC* can see no good reason to prevent reputable local companies from buying stakes in stockbroking companies should they wish to do so.

- 2.4 It is the view of the SESRC that the regulation of ownership should be lifted altogether for local corporations and individuals. Financially sound local entities should be allowed to buy stakes of any size in local member companies. The SES would retain the right to reject substantial stakes if there are grounds to believe that the proposed participants are of unsound character or financial standing. The SES will continue to regulate the approval of the persons appointed to manage the businesses. **(Recommendation 1)**
- 2.5 The SESRC anticipates that with the freeing up of ownership regulations, and other measures to liberalise the sector, less progressive members of the SES are likely to leave the industry, or merge with stronger participants. Corporate shareholders will enter the picture, bringing with them fresh ideas, capital and professional management with which to drive new products and services. Whilst there is no guarantee that the remaining firms will be innovative enough to thrive, the threat of progressive liberalisation should help to focus their minds on the forces of natural selection.

### **3 THE STRUCTURE OF COMPETITION – FOREIGN PARTICIPATION IN THE SECURITIES INDUSTRY**

- 3.1 The SESRC has also examined the avenues for foreign participation in the SES. There are evidently too many categories, and these should be streamlined (see Appendix 1 for details on different classes of foreign membership). The SESRC decided that the category of SESDAQ Associates should be eliminated eventually for the following reason. SESDAQ Associates were introduced in 1987 to grant non-member companies direct trading access to the newly created SESDAQ market by trading for retail investors in SESDAQ securities. As the local securities market matured, the role SESDAQ Associates has diminished in significance and they have become largely redundant.
- 3.2 At present, a foreign securities firm can choose to acquire a stake in a full-service SES member, but this stake is limited to 49% in the first instance, rising to 70% if the foreign partner can show that it has contributed to the development of the industry. Foreign houses can also become international members (*IM*) which can trade with any international client but can only deal on the SES with local clients transacting in excess of S\$5 million at a time. There are also Approved Foreign Brokers (*AFB*) which are locally incorporated and capitalised at a minimum of S\$3 million; these can trade directly on the SES in foreign currency listings. The numbers of AFBs have been dropping because of mergers and closures, so that only five are left. All the above categories are regulated by the SES. There are foreign brokers (*FB*) who operate with a dealers' licence from the MAS. The FBs do not fall under SES regulations. Their trades are usually booked via Hong Kong, and their dealers are not required to pass the local dealers' examinations.
- 3.3 The SESRC is unanimously of the view that all securities professionals dealing in SES-listed and/or quoted securities should meet the same qualification standards, and strongly recommend that all dealers whether in member firms or FBs who deal in SES-listed and/or quoted securities should be required to pass the Dealer's Representative's (*DR*) examinations conducted by the SES. Securities professionals dealing solely in non-SES listed and/or quoted securities should either possess a DR Licence or possess an appropriate professional qualification to deal in those securities. **(Recommendation 2)**



- 3.4 The SESRC discussed the integration of AFBs into other classes of membership. Data from the SES shows that the AFBs have not materially contributed to turnover in foreign currency stocks (S\$983 million in 1997 against S\$183 billion for the market). However, since it will be difficult to remove existing privileges from AFBs, the SESRC agreed that no additional AFBs would be admitted, and that existing AFBs would be encouraged to seek IM status. **(Recommendation 3)**
- 3.5 The SESRC agreed that it is in the national interest to have a continued and significant local presence in the domestic securities industry. The rapid consolidation and liquidation of international securities firms operating in Asia points to an instability in commitment. The development of a stable, competitive securities industry in the long term needs participants who are rooted to Singapore and able to expand into the region.
- 3.6 The SESRC examined ways of opening the market to greater competition while giving local firms enough time to consolidate and develop their scope of activities.
- 3.7 It was agreed that in the longer term, the remaining restrictions on IMs and the cap on foreign ownership of full members could be removed. Since IM licences were sold with specific restrictions, however, it was felt that there should be a fee attached to the conversion of their licences. A maximum period of 5 years is recommended for these changes to take place. However, the means by which foreign firms participate on the Exchange will depend on a review of the structures of governance for the SES. In the light of recent changes in major overseas exchanges, the merits of separating ownership of the SES from participation as a member, e.g. through demutualisation, need to be studied. The SESRC understands that this will be done under the ambit of the McKinsey-MAS review. **(Recommendation 4)**
- 3.8 Until governance issues are settled by the McKinsey-MAS review team, it is recommended that a consistent policy be applied to foreign participation in SES member firms. During this period, foreign securities firms in joint ventures should be allowed to increase their equity stakes to 70%, rather than the 49% that applies to most at present. Similarly, new acquisitions by foreigners in local member firms should be capped at 70%. Foreign securities firms which desire 100% ownership immediately should be allowed to buy out their local partners, but would, during this interim period, have to operate under IM rules rather than as full members. Conversely, existing IM firms which wish to broaden their activities to the retail arena ahead of full liberalisation should be allowed to convert to a full membership as long as they sell 30% of the company to a local entity. **(Recommendation 5)**
- 3.9 The SESRC examined current restrictions on IM firms. The original intention of the rule restricting trade with local residents (to transactions of >S\$5 million) was because IMs were expected to infuse expertise and enlarge the pie by making the market more accessible to foreign investors. It was not intended that they should replicate the remisier network already in place. However, as more international fund managers have set up in Singapore, this restriction has had an unintended effect of preventing an IM from trading directly for financial institutions that have moved to Singapore. The SESRC therefore recommends that IMs should be allowed to trade freely with any foreign clients and with any SES-approved local financial institutions. However, the restriction on trade with other local clients should remain at S\$5 million. **(Recommendation 6)**
- 3.10 Under current SES policy, representatives of IMs are not eligible for election to the SES Committee and they cannot vote on any resolution for the election of SES

Committee members. Such restrictions on an IM's share in SES may discourage quality foreign houses from seeking International Membership. As full SES members, IMs should have the right to be represented on its governing body as well as the right to elect its members. The SESRC therefore recommends that this policy be abolished immediately. Presently, four of the nine SES committee members are elected by members in the general meeting. Bearing in mind that IMs do not have a remisier base, the SESRC recommends that at least half of the elected SES Committee members should be representatives of majority local firms to ensure that the interests of retail investors are not overlooked. **(Recommendation 7)**

#### **4 ISSUE OF NEW SEATS**

- 4.1 The SESRC expects that liberalisation of ownership will lead to considerable restructuring of the local membership. Local demand for memberships can probably be satisfied by the sale of existing firms. As ownership change and industry consolidation are desirable, the SESRC recommends that in this transitional phase no new local seats should be issued at least until 1 January 2000, so as to channel nearer-term demand towards the renewal of existing firms and encourage the process of consolidation. The merger of local firms will generate a surplus of seats which will be sold since there is no economic benefit to owning more than one seat. If market forces show a surplus demand for full memberships, the SES should consider issuing new seats after 1 January 2000 in so far as the current ownership structure of the SES remains. **(Recommendation 8)**
- 4.2 As for the issuance of new International Memberships, there was doubt that issuing more IM seats would result in increased commission-generating business for the industry as a whole; it would mostly lead to a redistribution of the existing pie. The objective of liberalising foreign participation should be to attract those FBs who can bring more than just mainstream agency broking into the SES. For instance, certain international securities firms would be desirable for their broad skills and technology in a wide range of products such as derivatives and index options. Past experience with foreign members has not been highly satisfactory in terms of their contribution to the development of products and the expansion of listings; most have remained dependent on mainstream agency broking. As shown in Appendix 2, IMs constitute a relatively small 12% of market turnover.
- 4.3 The SESRC considered the issuance of new International Memberships to meet the demand shown when Yamaichi's seat was tendered in December 1997. In the event that the current governance structure is retained, it was agreed that new IM seats can be sold by way of tender, with firms prequalifying based in part on their ability to participate in the development of new product and service areas. One proposal was that the floor price should be no lower than the last successful bid for an IM seat. In determining the minimum price, the SES should bear in mind the financial contributions over the years of the existing 33 members, and the cash reserves of over S\$400 million which act as an implicit guarantee of the system's financial integrity.
- 4.4 If however the authorities wish to reduce the entry price, the McKinsey-MAS group may wish to examine the issuance of trading rights in place of shares in the SES as part of its broader study on SES structures. These rights could be priced at a lower level. The existing shares in the SES could either continue to be held by members, with the possibility of an eventual floatation of the SES, or they could be bought back by the government. Further study will be required. All these issues relating to the

issuance of new International Memberships should be deferred until the conclusion of the McKinsey-MAS study on governance structures. **(Recommendation 9)**

## **5 COMMISSION RATES**

- 5.1 The SESRC has noted the recommendations of the Finance & Banking Sub-Committee chaired by Mr Peter Seah. In respect of commission rates, it recommended that "Singapore's fixed brokerage should be reviewed to ensure securities transaction costs are competitive. Free brokerage rates for institutional investors and review brokerage for retail investors". The SESRC also noted DPM BG Lee Hsien Loong's decision to eventually allow market forces to determine commission rates, with perhaps a 2-3 year adjustment period.
- 5.2 In order to make recommendations on the pace and scope of liberalisation, the SESRC examined the competitive structure of the broking industry; its degree of reliance on commission incomes; and the likely impact of rate liberalisation on revenue streams. The SESRC accepts that some degree of pain and revenue loss is inevitable, but also argues that the process should not be so disruptive as to cause sudden and widespread business closures. Change will be costly, requiring much investment in technology and personnel at a time of increased competition and falling revenues; firms need time to adapt.
- 5.3 The SESRC is of the view that commission liberalisation should be phased in. For reasons outlined in the first part of this report, the local industry has been constrained from ownership change over the past decade. Business development has also been limited beyond the area of agency broking, though there have been moves by some firms to innovate in electronic broking and corporate finance in the past three years.
- 5.4 According to SES, more than 90% of the income of member firms comes from commission income. This is much higher than the 49% figure for New York brokers in 1974, ahead of their Big Bang. A sudden and steep fall in commission rates would send a significant number of broking firms into loss. The SES, at the request of the SESRC, has conducted simulations based on different scenarios to examine the impact of lower commission rates on the industry's aggregate revenues and profitability, and on the profitability of existing members.
- 5.5 A sudden, steep cut in commission rates could also have a negative effect on foreign participation in the local securities market. The Singapore equities market is at present limited in scale and growth potential. The major income stream for foreign securities houses in Singapore comes from agency commission income, though some are also active in corporate finance and in proprietary trading. The desirability of an International Membership is at present linked solely to commission savings; whilst new product lines are potentially exciting, these will take time to become profitable for participants, given significant startup and operating costs. Reduced commission rates without compensating business opportunities could have the unfortunate side-effect of deterring membership in the SES. Given the likely length of time needed for implementing changes, it is unlikely that a broad range of new products and/or services will be available before mid-1999, and it will take at least a year before successful participants begin to make money.
- 5.6 Appendix 3 shows a breakdown of income from different sizes of transactions. Though there are overlaps, we assume for simplicity that any transaction of under S\$250,000 is for retail customers, and anything greater is for institutional clients.

Using this measure, it is assumed that 60% of turnover in the market is for smaller customers, and 40% for institutional clients and principal trading. Separately, it is noted that 46% of market turnover in 1997 related to Malaysian companies on CLOB International (40% in 1996); almost all of this trade is done by retail customers or by broking firm house accounts, as institutional customers normally prefer to deal through the home market.

- 5.7 The SESRC does not expect that institutional transactions will increase materially because of commission rate cuts: professional fund managers do not churn portfolios for the sake of an extra few basis points. In 1995, the SES reduced the minimum rate for transactions of over S\$1.5 million from 0.5% to 0.3%. This was a significant reduction for large trades, but according to SES data, industry volumes rose by only 2.4%.
- 5.8 The SESRC agreed that reduced rates would not lead foreign brokers to book more of their large block trades in Singapore, as the main reason for Hong Kong's dominance as a booking centre is its lower corporate tax rate. The SESRC generally feels that encouraging more foreign brokers to set up as members of the SES will be a more effective way of bringing these trades to Singapore, in part because there would be an increased local cost base to offset the revenues from such trades.
- 5.9 With 60% of revenues earned from smaller transactions, the SESRC generally agreed that brokerage rates for such transactions could not be significantly reduced without threatening the existence of many local firms before they have had time to restructure their operations. Substantially lower rates could also spark higher volumes for retail client transactions in volatile periods, but a sharp increase in speculative activity may not be desirable. A sudden implosion in retail revenues would make it very difficult for local firms to generate the resources needed to pay for the transition towards a more competitive future.
- 5.10 The SESRC noted that the SES may launch a low-cost internet broking system catering to small customers. This system may reduce broking industry revenues. Further near-term negative impact on retail broking revenues will come with the shortening of settlement periods to T+3, which will curtail contra trading, a major source of revenue. Both these developments will erode the profitability of member firms at a time when revenues are needed to fund restructuring.

## **6 COMMISSION RATES – RECOMMENDATIONS**

- 6.1 The SESRC recommends that, as a first step, various impediments and anachronisms be removed. These would immediately lower the cost of transactions for institutional accounts, while giving the broking industry a period of time in which to prepare for broader liberalisation.
- 6.2 The SESRC generally agrees that amalgamation of trades should be allowed with immediate effect. At present, commission rates are set on a sliding scale from 1% to 0.3%, based on value. If a fund manager deals for a number of different accounts, each of these is treated as a separate order and commissions for each account are calculated independently. The SESRC recommends that amalgamation should be allowed for approved fund managers. This will lower the effective commission rate charged to fund managers. **(Recommendation 10)**
- 6.3 The SESRC also considered whether other financial institutions, in addition to banks and approved fund management companies, should enjoy a 25% brokerage rebate.

Banks and merchant banks have historically been paid a 25% rebate on commissions on transactions booked through them. This was to compensate them for effectively guaranteeing client transactions. In addition to banks, fund management companies holding an Investment Adviser's (IA) licence, Approved Fund Managers under the Tax Exemption Scheme for Fund Management and off-shore fund management companies which are registered with SES as eligible off-shore fund management companies for the purposes of the rebate are also granted a rebate of one-quarter of the brokerage in respect of transactions in securities listed or quoted securities on the SES.

6.4 The SESRC agreed that fund management companies which are exempt IAs managing the accounts of not more than 30 sophisticated investors under Regulation 41(1)(e) of the Securities Industry Regulations should also enjoy this rebate with immediate effect until commissions become freely negotiable for large trades on 1 January 2000. The SESRC also agreed to extend the rebate to finance companies to bring the practice in line with that for banks. In addition, rebates should be extended to life insurance companies which are acting as fund managers for policyholders. **(Recommendation 11)**

6.5 The SESRC recommends that commission rates be amended as follows:

Current:	<\$250,000	1% [minimum commission \$2]
	Next \$250,000	0.9%
	Next \$250,000	0.8%
	Next \$250,000	0.7%
	Next \$500,000	0.5%
	>\$1,500,000	0.3% (negotiable to)

**With effect from 1 January 1999**

Proposed: Minimum commission rates to be reduced by 5% for all transactions  
[minimum commission \$10]  
**(Recommendations 12 & 13)**

**With effect from 1 January 2000 :**

Proposed:	≤\$150,000	Minimum of 0.75% [minimum commission \$10]
	>\$150,000	Fully negotiable <b>(Recommendation 16)</b>

Fully negotiable for all approved fund manager trades

**By 1 January 2003 :**

Fully negotiable for all trades **(Recommendation 19)**

6.6 To give impetus to the reform programme, it is recommended that minimum commission rates be reduced by 5% for all transactions for the period from 1 January 1999 to 31 December 1999. **(Recommendation 12)**

- 6.7 It was also agreed that minimum commission rates per contract should be raised from \$2 per contract to \$10 from 1 January 1999 to more realistically take into account processing and handling costs. **(Recommendation 13)**
- 6.8 To generate interest in the markets for pure fixed income securities and non-Singapore dollar denominated securities, the SESRC also recommends that from 1 January 1999, the commission for trades in these securities should be fully negotiable. **(Recommendation 14)**
- 6.9 In the process of liberalisation, rebates should be eliminated and banks can add charges to their customers' bills, should they wish to do so. The SESRC generally agreed that rebates will no longer be relevant from 1 January 2000 and should be eliminated. **(Recommendation 15)**
- 6.10 The SESRC proposes that with effect from 1 January 2000, trades of less than \$150,000 should be charged a minimum commission rate of 0.75%, while commission rates should be freely negotiable for trades larger than \$150,000 in value. **(Recommendation 16)**
- 6.11 The case for minimum retail commissions to be set at 0.75% from 1 January 2000 is based on simulations found in Appendix 4. The SES data shows the impact on the range and number of profitable firms using two different rates for small trades: 0.5% and 0.75%. Data for the past five years is given. Based on 1997 figures, and assuming that larger trades settle at a 0.2% rate (which the SESRC considers the most likely scenario), the number of profitable firms will fall from 28 (actual) to 24 (at 0.75%) and 15 (at 0.5%). However, aggregate industry pretax profits, which were S\$450 million in 1997, would fall to S\$190 million (at 0.75%) and S\$28 million (at 0.5%). It will be noted that the SES data adopts S\$250,000 as the cut-off point for small trades and not S\$150,000 as recommended by the SESRC. The SESRC considers that small trades should be redefined to mean trades valued at less than S\$150,000 and thinks that the implications of the likely impact due to reduced commission rates which may be drawn from SES' data would still hold. There would of course be both winners and losers, and consolidation would bring about efficiencies, but in the opinion of the SESRC, these benefits are no more than the required return for the consolidation of the industry into more efficient and dynamic participants.
- 6.12 The SESRC recommends that from 1 January 2000, commission rates for approved fund managers (i.e. fund managers holding IA licence, Approved Fund Managers under the Tax Exemption Scheme for Fund Management and exempt IAs under Regulation 41(1)(e) of the Securities Industry Regulations) should be freely negotiable for the full quantum of any transaction, even if less than \$150,000 in value. This recommendation takes into account the reality that most institutional clients prefer to work with a single, equally-applied rate rather than a sliding scale. **(Recommendation 17)**
- 6.13 The deregulation of commission rates is part of an overall effort to make Singapore more competitive as a financial centre. While recommending significant reductions in commission rates, the SESRC urges the government to do its part in lowering transaction costs by eliminating stamp duties and GST for securities transactions with effect from 1 January 2000. **(Recommendation 18)**
- 6.14 The SESRC recommends that commission rates should become fully negotiable by 1 January 2003. It urges the authorities to examine closely the impact of earlier

stages in the deregulation programme before deciding on any acceleration of this timetable. **(Recommendation 19)**

## **7 CONCLUSION**

For ease of reference, a summary of all the above recommendations is set out in Appendix 5.

## REGULATORY ENVIRONMENT

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### 1 INTRODUCTION

- 1.1 The SESRC also reviewed all aspects of the operations of securities firms, including capital and other financial requirements, rules and regulations governing their activities. The study was made with a view to improve the regulatory environment for securities companies operating in Singapore, so as to facilitate their development, provide greater transparency in regulations as well as enhance the competitive edge of the Singapore securities market.
- 1.2 In making its recommendations, the SESRC had considered the feedback received from SES member companies (including the International Members) on the Securities Industry Act (*SIA*), Securities Industry Regulations (*SIR*) and SES Rules and Bye-Laws.

### 2 SES INTERNAL GUIDELINES (Recommendation 20)

- 2.1 The SESRC had received feedback that the SES had sometimes responded to member firms' queries by citing 'internal guidelines' which are not documented nor made known to member companies.
- 2.2 While there may be a need for internal guidelines in regulating members, they should be kept to a minimum. The SESRC therefore recommends that the SES should minimise the use of administrative discretion. Any policy or requirements to be imposed on member companies should be set out in practice notes and issued to all member firms. Such practice notes should also include matters on interpretation of the SES rules and bye-laws. This would assist member firms to comply fully with all the Exchange's requirements and provide for more transparency in regulations. The SESRC understands that there is a SES Secretariat team to look into members' enquiries and matters. Member companies should be encouraged to consult this team if they need clarification on the SES' requirements, interpretation of rules, etc..

### 3 TRUST ACCOUNT REQUIREMENTS (Recommendation 21)

- 3.1 Under the current trust account requirements in the SIA and SES Bye-Laws, all clients' monies are required to be held in banks in Singapore. Based on member companies' feedback, it is prohibitively expensive to maintain foreign currency trust accounts in Singapore. In addition, with markets in different time zones, maintaining a trust account with a bank in Singapore creates the problem of remitting the funds to these countries on time.
- 3.2 The SESRC therefore recommends that the trust account provision be amended to allow clients' monies in foreign currencies to be held in banks outside Singapore, provided that the prior consent of the client is obtained. Such overseas banks should, however, have credit rating of above certain standard.

### 4 COMPUTATION OF ANC (Recommendation 22)



- 4.1 The SESRC had received feedback that the rules on ANC computation should be amended to allow dealer's representative's (*DR*) monies retained by a member company to be offset against clients' contra losses. While such monies do not represent the member company's operational funds as any monies belonging to DRs have to be kept in a separate trust account, the SESRC notes that in practice, it would be more difficult to sue a client for contra losses than to recall DRs' deposits. Accordingly, the SESRC supports the proposal that in computing a member company's ANC, clients' contra losses should be reduced by their DR's monies retained by the member company.
- 4.2 In addition, for consistency with the settlement provision in the SES Bye-Laws (which is based on market day), the SESRC recommends that the "haircuts" for outstanding contracts be based on "market day" instead of "calendar day".

## **5 LIMIT ON AI (Recommendation 23)**

- 5.1 Presently, under the SES Bye-Laws, the AI of a member firm shall not exceed 5 times of its ANC at all times. On the other hand, the SIR limits a member firm's AI to not more than 6 times of its ANC. If a member firm's AI exceeds this amount, it shall notify MAS and SES as soon as practicable, but not later than the next business day. The member firm's dealer's licence shall lapse if its AI exceeds 8 times of its ANC for 4 consecutive weeks.
- 5.2 The SESRC is of the view that the present limit on a member firm's AI is on the low side compared to that in other jurisdictions such as Hong Kong. In addition, sufficient safeguards such as limits on single client exposure, single security exposure and investment limits are already in place to ensure that member firms operate prudently. Therefore, the SESRC recommends that the limit on a member firm's AI in the SES Bye-Laws be raised to 7 times ANC while that in the SIR be increased to 8 times ANC before the notification requirement would be triggered, and 10 times ANC before its dealer's licence would lapse. The stricter requirement under the SES Bye-Laws is to serve as a buffer against violation of the law by a member company.

## **6 MAINTENANCE OF RESERVE FUND (Recommendation 24)**

- 6.1 Under present rules, every member company shall maintain a reserve fund which is not available for distribution as dividends. Each member company shall transfer an appropriate amount to the reserve fund out of its net profits of each year after due provision has been made for taxation.
- 6.2 The SESRC had received feedback that the requirement that member firms transfer an appropriate amount to the reserve fund each year is not an efficient use of capital, especially for those member firms which have built up substantial amounts in the reserve fund. A suggestion had been made to amend the existing rules so that due consideration is given to member companies which have large paid-up capital and statutory reserves.
- 6.3 The SESRC is of the view that there are merits to the above suggestion. Accordingly, it recommends that the reserve fund requirements be modified to take into account factors such as the shareholders' funds and net cash position of member firms.

## **7 MARGIN ACCOUNT (Recommendation 25)**

- 7.1 The SESRC is of the view that in extending credit to a client to purchase a security, a member company is in a better position than the SES to assess the risk of financing the security and react to changing circumstances quickly. Therefore, the SESRC recommends that the rule on margin account should be relaxed to allow member firms the discretion to decide on the securities they want to finance. However, certain safeguards need to be in place to ensure that member companies do not overextend themselves to any particular client or over any particular security. The following requirements are proposed :-

Total credit extended by the member firm in all margin accounts should not exceed 3 times of the member firm's ANC;

The maximum exposure of the member firm to any particular margin client, inclusive of that client's related persons or company/group of companies controlled by that client, should not exceed 20% of ANC;

Only securities that are quoted on SES, CLOB International and main board of recognised stock exchanges could be financed in margin account. For securities that are quoted on the main board of recognised stock exchanges, only those securities issued by companies which have shareholders' funds of not less than S\$200m (based on the last published accounts of the company) can be financed in margin account;

Total credit extended by the member firm for purchase of securities quoted on SES/CLOB International should not exceed 3 times of the member firm's ANC. In relation to securities quoted on the main board of recognised stock exchanges, the total credit extended by the member firm should not exceed its ANC; and

Total exposure of the member firm to any margin security should not exceed 5% of the issued capital of the company issuing that security.

- 7.2 In addition to the above proposal, the SESRC recommends that cash and securities deposited by a client as collateral and securities bought under the client's margin account and amount owed by the client under margin account should be fungible. The SESRC had received feedback that current restrictions on the fungibility of cash and securities deposited and traded have resulted in onerous operational difficulties for member firms as cash and securities deposited by a client have to be accounted for separately from the securities bought under the client's margin account and the amount owed by the client for the purchases. The SESRC is of the view that such restrictions can be removed without compromising credit control risks as safeguards such as limits on exposure to single client, single security as well as margin requirements are in place to ensure that there is no overexposure and excess credit to any particular client.

## **8 LIST OF RECOGNISED STOCK EXCHANGES (Recommendation 26)**

- 8.1 Under the current SES Bye-Laws, a member company has to deduct from its ANC the full book value of securities carried in the member company's own account if the securities are not quoted on the SES or on the main board of a recognised stock

exchange. In addition, the Bye-Laws limit a member company's exposure to any such security to only 1 time of ANC while the exposure to a security that is quoted on the SES or a recognised stock exchange can go up to 3 times of ANC. Except for the Stock Exchange of Thailand and the Kuala Lumpur Stock Exchange, the rest of the stock exchanges in the region are not recognised stock exchanges.

- 8.2 To encourage member firms to trade more regional securities, the SESRC recommends that the list of recognised stock exchanges be expanded to include other regional stock exchanges such as the Jakarta Stock Exchange, Philippines Stock Exchange, Shenzhen Stock Exchange, Shanghai Stock Exchange and Mumbai Stock Exchange.

## **9 SETTLEMENT PERIOD (Recommendation 27)**

- 9.1 The SESRC notes that a shorter settlement period could reduce credit and settlement risks, encourage more overseas custodians to set up in Singapore, and promote the development of margin financing activities in Singapore. Accordingly, and in line with the G30 recommendations, the SESRC proposes that the period for settlement of share transactions be reduced from T+5 to T+3.

## **10 PROVISIONS IN ANNUAL ACCOUNTS (Recommendation 28)**

- 10.1 Presently, member firms' provision for contingency and general provision in annual accounts are not tax deductible. To encourage member firms to make provisions for contingencies in their financial statements in good years which may be drawn upon in bad times, the SESRC recommends that tax deduction for member firms' provision for contingency and general provision (similar to those permitted for banks for their provisions for bad and doubtful debts) should be allowed. It is improbable that there would be abuse of this tax benefit as any provisions made in the accounts have to be audited by independent external auditors. Moreover, any provisions made that are subsequently recovered would be subject to tax. While there may be concern that such tax deduction could encourage member firms to undertake more risks, the SESRC is of the view that it is unlikely that member companies would do so as the savings arising from the tax deduction is small compared to the losses that may arise from the increased risks.

## **11. OTHERS (Recommendation 29)**

- 11.1 In addition to the above proposals, the SESRC also made a number of recommendations which are less substantive but nevertheless would enhance the operations of securities firms. These are contained in the attached Appendix 6.

## SCOPE OF ACTIVITIES

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### 1 INTRODUCTION

- 1.1 This part includes the recommendations to develop new financial products and additional services within the existing licensing framework for members of the Stock Exchange of Singapore (*SES*).
- 1.2 The SESRC notes in its study the availability of a wide spectrum of financial products and services in developed markets like New York, London and even Hong Kong. The SESRC views the approach to totally replicate these products and services in the local market as untenable as Singapore might not have the infrastructure and expertise to develop them in the short run. Moreover, it must be borne in mind that there would always be newer products and services developed and traded in these developed markets.
- 1.3 The SESRC observes the need to develop specific financial products and services that are critical to enhance Singapore's financial sector position in the region. To achieve this, the SESRC is of the view that SES members should be permitted to expand their scope of activities and services within the regulatory definition of their dealing licence relating to securities-related activities.
- 1.4 The original proposal was to rename member dealers as "Investment Financial Services" (*IFS*) firms and depending on shareholders funds, grade players into 4 categories. These firms should automatically be allowed to expand into additional security-related activities under core and non-core activities based on the categories they are in (see Appendix 7 - Paper on Licensing Requirements). This liberalisation measure would have ultimately given SES members the flexibility to progressively pursue new securities-related business activities that are currently unavailable in the market without being "boxed in" by licenses.
- 1.5 However, the proposal would require a complete overhaul of the existing regulatory and licensing framework. This is recommended for long term considerations as it removes the mind set that dealers are restricted to share activities only. In the short term, the immediacy of the need to provide SES members an environment to expand their scope of activities demands that recommendations be made under the existing regulatory framework.
- 1.6 Furthermore, we understand that under the new regulatory environment, the policy has become more liberal and now SES members could apply successfully for the investment adviser's (*IA*) licence for fund management activities and should be encouraged to do so under the existing licensing structure. Hence the existing infrastructure for licensing requirement should remain for the time being.
- 1.7 Under such context, the SESRC is of the view that the regulatory authorities would promote and facilitate the application of an IA licence by SES members.
- 1.8 The SESRC proposes the following recommendations: fund management activities, self regulatory environment, development of new products, development of infrastructure for trading the debt market by SES members, development of a single

operating systems to book trades, the formation of a tax issues working group and other issues.

## **2 FUND MANAGEMENT ACTIVITIES**

- 2.1 The SESRC sees investment portfolio management as a natural progression for stockbrokers to expand their scope of activities. In the UK and US, fund management activities have increasingly emerged as a growing segment of the stockbrokers' business and have contributed substantially to their profitability. With expected lower margins from commission income in the future, SES members could 'graduate' to manage clients' funds to earn management fees as an added source of income, or alternatively in a non-discretionary basis, financial planning fees.
- 2.2 At the same time, SES members have an advantage of a wide retail-based distribution network to tap an enormous source of potential investible funds. The SESRC believes that this segment of the financial industry should be gradually opened to allow SES members with the necessary research, marketing expertise and established clientele base to participate.
- 2.3 The SESRC recommends that the authorities facilitate the application of SES members for an IA licence to act as investment advisers and financial planners **(Recommendation 30)**. This would allow the member firms acting in their capacity as investment advisers to solicit for investing clients, to manage funds, to collect fees and commissions on their investment advice and to distribute their own or third party funds. The authorities should consider reducing the paid-up capital requirement for SES members to qualify for an IA licence if they meet other prerequisites such as research capabilities.
- 2.4 The SESRC recognises that present regulation do not favour start ups or boutique fund managers (exempt). But as this issue is being addressed to lower the barriers for start ups or boutique fund managers without damaging Singapore's reputation, the SESRC fully supports this measure.
- 2.5 To develop Singapore as a financial centre with an active fund management industry, the SESRC recommends that the current tax regime be changed to accord the same tax benefits to investment firms managing either resident or non-resident funds. Currently, foreign fund managers who manage \$1 billion non-resident funds enjoy a concessionary tax rate of 10% while all fund managers who manage more than \$5 billion non-resident funds enjoy a tax exemption period from 5 to 10 years. The SESRC recommends that local fund managers who manage the same amount of resident funds should also be accorded the same tax benefits. Being a development concept, these tax benefits should last for three years. **(Recommendation 31)**

## **3 SELF REGULATORY ENVIRONMENT**

- 3.1 To ensure that SES members, having obtained the IA licence, are suitably qualified to give investment advice, the SESRC recommends that qualifying examinations should be made mandatory for all the professionals who provide investment advice. These market professionals should be suitably tested to attain the required knowledge to understand the risk characteristics of any product or service offered. The authorities may consider requiring continuous education and tests for these market professionals. **(Recommendation 32)**

- 3.2 The SESRC views with importance the need to require fund managers to regularly provide mandatory periodic and standard performance presentations to the public. The information to be provided include the investment's performance, fees charged and the qualifications of the managers. This disclosure should be made readily available on accessible media sources. This disclosure measure is deemed necessary to allow the investing public to have a broader background information on the managers such that the onus is on the investors to choose the managers to manage their investments. Coupled with this recommendation is a parallel requirement for fund managers and SES members to come up with in-house 'suitability policies' for its products when sold to investors. **(Recommendation 33)**
- 3.3 As the financial industry continues to grow in Singapore, there may arise a need for investment advisers to insure themselves against professional negligence. This recommendation should encourage investment advisers to adopt professional accountability and provide the investing public with a recourse against negligence. **(Recommendation 34)**
- 3.4 In line with recommendation 34, the authorities may consider sponsoring a neutral arbitration board made up of practising professionals both inside and outside the industry to resolve disputes arising from any dealings in securities. **(Recommendation 35)**

#### **4 DEVELOPMENT OF NEW PRODUCTS**

- 4.1 The SESRC is of the view that new products should be developed in the Singapore market to broaden and deepen its scope. A wide variety of new investment and risk hedging products would encourage more foreign financial players to establish a presence in Singapore to participate in this new business segment. The SESRC recommends that regulatory and tax structure be adapted to accommodate the development of the following products.

##### **4.2 Securities Borrowing and Lending (SBL) (Recommendation 36)**

SBL remains fundamental to the development of a successful derivatives market in Singapore. The SESRC understands that although the legal mechanisms have been put in place to allow for the development of an SBL program in Singapore, certain unresolved tax issues have hindered its successful implementation. These include the treatment of tax on SBL transactions and manufactured dividends. (see Appendix 8 - Paper on Development of SBL Program)

##### **4.3 Regulated Short Selling (Recommendation 37)**

The SESRC also advocates that the authorities monitor and provide more transparency to the rules governing short selling on the SES. This would allow more activities to be booked onshore and also allow for the monitor of short open interest for macro control. (see Appendix 9 - Paper on Regulated Short Selling)

##### **4.4 SES Listed Stock Index Options (Recommendation 38)**

Singapore remains one of the few developed financial markets where a local equity option index is not traded on the stock exchange. To provide investors with an instrument to hedge their investments in the cash market, it is imperative that a local stock index options product in Singapore dollars on the SES be developed. This product is essential for fund managers who cannot operate futures margin accounts

on the Singapore International Monetary Exchange (*SIMEX*). The development of regional stock index options in US dollars should also be considered to capitalise on the regional stock markets' growth when the regional economies recover. The SESRC also recommends that the SES and/or sponsoring member develops the country basket shares of regional and global stock indices (either listed or OTC). This would allow investors to have an easily available investment vehicle to the regional and global stock markets via the country basket shares.

#### 4.5 Listed Property Trusts (*LPTs*) & Real Estate Investment Trusts (*REITs*) **(Recommendation 39)**

LPTs/REITs are investment trusts instruments that invest primarily in real estates. In the US in the 1980s, REITs received favourable responses from the investing public due to the tax incentive provided to the holders of these instruments. The concept of REIT is basically a limited company or LPT as a closed ended fund whereby the earnings streams from investments in real estate are not taxed at the corporate level but are filtered down to the investors' level. Individual investors are then taxed on these returns based on their tax brackets. LPTs/REITs would provide the Singapore market with a new investment product that can be listed on the SES that may prove to be highly in demand (see Appendix 10 - Paper on Development of LPT in Singapore).

The SESRC recognises that REIT is a resultant that sprang out of a range of 'tax incentive vehicles' designed to encourage investment flows into areas that are desirable for the national interest but lack private capital that is;

- (i) specialised skills like "movie making";
- (ii) research and development like "biotechnology";
- (iii) high financial risk activities like "oil exploration"; and
- (iv) essential areas like "real estate" where investment flows would continue to be less due to declining yields and perceived capital losses. It is in the national interest that property prices do not collapse.

#### 4.6 Electronic Bulletin Board to be Created by SES **(Recommendation 40)**

GDRs issued on Korean and Indian securities are actively traded on the Hong Kong over-the-counter (*OTC*) market. The restriction on foreign ownership of these two national securities, together with the less-than-developed clearing and settlement systems in India, has created a window of opportunity for other financial markets to develop a trading mechanism for these securities. The huge Asian convertible bonds market traded OTC, which is highly inefficient in pricing and transparency, is another potential market which the SES should consider tapping.

SES should consider creating first an electronic bulletin board for brokers to indicate trading interest in these securities and to trade them OTC. Subsequently, SES could develop the electronic bulletin board into an organised OTC market for these securities subject to a review of its feasibility. In trading these instruments, members would be encouraged to add new products, develop expertise and sell to end customers as well.

Trading rules such as rules on fair practice, minimum obligatory dealing size, procedures, participants and arbitration can be developed based on the US NASDAQ model.

#### 4.7 Equity and Debt Derivatives Instruments including OTC (**Recommendation 41**)

To help kick-start the SES options market, the SESRC sees a need to broaden the scope of the market by launching options on more equity and debt securities, even CLOB Malaysian securities. SES should also consider adopting more innovative derivative products like the share ratio contracts traded on the Australian Stock Exchange (ASX). Share ratio contracts measure a specific security's price performance relative to the overall market by dividing the share's last done price against the index. These contracts are traded based on the expectations of the security's performance against the market's.

4.8 The SESRC notes that a detailed description of some of the above products are included in the SES' internal papers. A careful study of these papers is necessary to understand the required procedures and mechanisms to develop these products.

### 5 DEVELOPMENT OF INFRASTRUCTURE FOR TRADING THE DEBT MARKET BY SES MEMBERS

5.1 The SESRC notes that the Sub-Committee on Banking and Finance has submitted a series of recommendations to the government to develop the debt market and the corresponding responses from the government. The SESRC is of the view that the accepted recommendations by the government should be vigorously pursued with a medium term outlook to create a vibrant debt market in both Singapore dollar and foreign currencies. The SESRC also notes the existence of a Monetary Authority of Singapore (MAS) project team working on the framework of a debt market in Singapore and recommends that the recommendations of this report be taken into account together with the results of the MAS study .

5.2 The SESRC recommends the following broad measures to develop the infrastructure for trading debt securities by SES members. (**Recommendation 42**)

#### 5.3 Government Initiatives

- (i) Recommend the government provide a benchmark yield curve by being a regular issuer of government securities of varying maturity.
- (ii) The interest on government securities should be market driven to provide a 'true' risk free return.
- (iii) Government and GLCs to issue medium and long-dated securities to fund specific infrastructure projects and investments.

#### 5.4 MAS' Role

- (i) MAS to sponsor the establishment of a mortgage securities vehicle to encourage development of a national mortgage-backed securities market.
- (ii) Guidelines to be established for dealing in debt securities such as allowing short selling of government securities within established guidelines.



- (iii) Establish guidelines on derivatives trading and futures contracts such as only allowing approved individuals to trade, and imposing daily price variation limits.
- (iv) Set up centralised securities information system to provide up-to-date information on all debt securities.
- (v) To allow for free participation by foreign financial institutions in the 'wholesale' area of Singapore dollar government securities.

#### 5.5 Active Secondary Market

- (i) MAS can perform a passive market-making role in government securities to provide better liquidity and marketability.
- (ii) High quality medium and long-dated debt issues by GLCs and financial institutions should be encouraged and allow these papers to be eligible as repo securities for discounting.
- (iii) Should selectively allow supnationals and OECD countries to issue long-term bonds here in Singapore dollars.

#### 5.6 Supporting Infrastructure

- (i) SES to sponsor a recognised credit rating agency.
- (ii) SES to simplify the listing requirements and procedures for debt securities and also to review the transaction costs.
- (iii) SES members to develop trading rules, requirement for dealers and capital/credit controls.
- (iv) To implement a delivery versus payment system for debt securities transactions. The clearing house should consider a link with Euroclear and Cedel and other recognized clearing houses.
- (v) A working group to be set up with the aim of developing a vibrant, competitive and efficient debt capital market.

### 6 SINGLE OPERATING SYSTEMS TO BOOK TRADES

(see Appendix 11 - Paper on Multi-currency Multi-asset Management Account)

- 6.1 The SESRC feels that the lack of a multi-currency multi-asset management system is the **biggest hurdle** to the development of the Singapore stockbroking industry.
- 6.2 US brokers like Merrill Lynch have employed a hugely successful cash management accounting system to grow into the global players that they are today. The basic concept of this system is to account for investor's assets, be it cash or securities for the brokers to manage under one financial statement rather than sending clients six different monthly statements for six different products. This system has been successful in retaining clients' loyalty to the same broker. Brokers have also learned to better manage client's portfolio by recommending putting the cash in other investment type instruments rather than 'churning' the account by recommending the

client to trade the capital or profits in the next trade just to derive commission income.

- 6.3 The SESRC recommends the creation of a single operating system known as multi-currency, multi-asset margin management account whereby all trades may be made through this account. **(Recommendation 43)**
- 6.4 The SESRC recommends changes such as reducing the Central Depository Pte Ltd's (*CDP*) transfer fees to allow frequent transfer of securities from SES members' DA sub-accounts to investors' direct accounts and vice-versa during the use of margining. Furthermore, the SESRC recommends a change in the existing SI Act to allow brokers to manage these cash or securities in one account (whether discretionary or non-discretionary). The system would sweep all surplus cash maintained in this account to invest in money market or unit trusts instruments to generate higher returns. The clients would receive a monthly statement on a timely basis, which would include all the multi-asset, multi-currency transactions and holding positions, including cash equivalent assets. The clients' cash or securities can also be managed by other investment advisers or kept by bank custodians. **(Recommendation 44)**
- 6.5 For this system to operate successfully, SES members would need to either interface with the SES operating systems or have information downloaded to them on a timely basis. For competitive reasons, SES members need to add on value to the monthly statement such as promotion of new products, regional securities, OTC transactions, profit and loss figures and even portfolio evaluation on a timely basis.

## **7 FORMATION OF A TAX/REGULATORY ISSUES WORKING GROUP**

- 7.1 The SESRC is of the view that the perceived tax on potential financial products and services to be developed in Singapore has not made their market prospects viable. The SESRC recommends that the IRAS, MAS, SES and the financial players form a working group to study the impact of tax and regulatory issues on the development of any new financial products or services. It is essential that this working group should begin to look at current viable financial products such as SBL and work towards removing any tax disincentive for its successful development and implementation. **(Recommendation 45)**

## **8 OTHER RECOMMENDATIONS**

- 8.1 The SESRC recommends that the Companies Act be amended to allow companies to buy back stock and keep them as treasury stocks. **(Recommendation 46)**

## ACKNOWLEDGEMENTS

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This review was the culmination of six months' effort which involved the participation of various groups of people in sub-committees. It was in these sub-committees where the substantive work was done. They were the people who had to slog through the details.

Mr Dominic Nixon of Price Waterhouse, Dr Tsui Kai Chong of Graduate School of Business, NUS and Mrs Ong Suan Ling of SES availed their expertise in financial products in our Scope of Activities Sub-committee.

The Monetary Authority of Singapore and Stock Exchange of Singapore were generous in providing us the information resources and the secretariat members, Mrs Carolyn Tan, Mr Alvin Tan and Ms Yap Huan Lan. Often under pressure, they were unflinching in their assignments.

We were encouraged by many of our colleagues and industry professionals who by their provision of resource materials and knowledge had made us more equipped to the task.

The views expressed, often not without intense debate, in this review are entirely our own.

### **SES Review Committee**

## **SES REVIEW COMMITTEE**

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Mr Goh Yew Lin	Executive Director GK Goh Stockbrokers Pte Ltd
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