

# **Market Regulation and Supervision**

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In my brief speech I will try and analyze the way we, at the Cyprus Securities Commission, view the role of market regulation & supervision and on the problems of supervision, (but also the advantages the supervisor has) in a small market and society as we have in Cyprus. I will not touch the well known Iosco principles of capital market supervision since they are available for all to read and provide a blueprint for proper and fair supervision.

## **INDIRECT (MARKET BASED) SUPERVISION**

One can imagine any capital market as a complex machine (let's say a car). Engineers among the audience will know that a well designed machine can operate to a large extent unattended ie work unsupervised and without human intervention, because some parts of the machine are there for the purpose of monitoring its proper functioning – in own car example the temperature of the car's engine is monitored by the thermostat that starts the fan when the engine begins to overheat, the fuel mixture is controlled by computers and sensors, the braking is monitored and controlled by anti-skid devices etc. etc.

There are many such self policing mechanisms in our capital markets – we have boards of directors that control and supervise what is happening in a listed company and non executive- independent directors that check the actions of executive directors; we have external auditors that audit the accounts of a publicly quoted company and financial analysts that see through the accountings tricks used to present a “rosy” picture of the company; we have the AGM where shareholders and, more notably, institutional investors, can “screen” the actions of directors; we have the lawyers and accountants that perform due diligence on prospective public companies to verify the contents of its prospectus and whose work in turn is supervised by the “sponsoring” broker; we have underwriters that, in turn, check the quality of the prospectus before deciding to underwrite and sell the issue; we have professional bodies that monitor the actions of their members-analyst associations, auditor bodies e.t.c. The system, in

other words, has a lot of in build check and balances. Not only the market has a lot of in build check and balances but it has also terrifying sanctioning and penalizing power as the collapse of Andersen after the Enron case, demonstrates.

We at the Cyprus Securities Commission believe that the art of correct capital market regulation and supervision is in the design of this (self regulating) machine, so as to have the market work on its own, without undue and burdensome state intervention and oversight. We need to design systems of incentives and penalties that force market participants to do their work properly and allow the market to work by itself with minimal supervision.<sup>1</sup> The supervisor's role thereafter is to fine tune the system by focusing his/her attention to problems as they arise and correct them by applying suitable regulatory sanction. The supervisor becomes the engineer that by turning a lever here, opening a valve there, fine tines the system.

Let me now switch to another analogy that can make the point clearer - that of the similarity of the capital market regulator and of a Chinese acupuncturist. The "trick" in acupuncture is to identify the correct pressure points of the body, apply the needles to these points carefully, and in turn ensures a properly functioning and healthy body.

Such pressure points, were correctly applied pressure can lead to big improvements in the healthy functioning of capital markets and were in Cyprus we focus our attention are the following:

- The workings of the Board of directors and the whole issue of corporate governance
- The relation of the auditor with the listed company
- The working of financial firms as providers of investment services

#### Board of Directors and Corporate Governance

One of the major issues we face in Cyprus at this point in time is the large number of companies that got listed during 1999-2000 (the time of the big bubble)<sup>2</sup>. These are companies that saw the market as an easy way for the owners to get rich quickly and also to take advantage of the "low cost of capital" that was available during the

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<sup>1</sup> Obviously there are preconditions for market bases supervision to work – transparency being the number are requirement.

<sup>2</sup> From 40 listed companies at the end of 1998 we have now 130.

bubble. The majority are small family businesses with little or no understanding of the responsibilities that they currently have to meet as public companies and the complex web of regulations that they need to comply with. The boards of directors are basically the owner and other family members, friends or relatives, with, again, little understanding of responsibility they carry as boards of a quoted company - from proper financial disclosure, to control of related party transaction, to the salaries that the owners/executives of the company get paid.

In this case the approach taken by the commission is one of gentle coaxing at the beginning and stick at the end: - on the one hand the commission is actively supporting the efforts of the local institute of Directors (a branch of the UK body) to bring professionalism and education to directors of public companies, while the commission has also acquired powers to fine directors of public companies for breaches of capital market regulations by the company they direct, and, in some cases, to disqualify them from serving on the board of listed companies. The trick here is to apply the correct level of pressure so as not to scare off those who understand their responsibilities but to gently ease out the “incompetent”.

In a parallel strand the Commission supports the efforts of the Cyprus Stock Exchange to introduce a Corporate Governance Code especially the parts of the code that deal with transactions of dominant shareholders with the listed company, the need for an internal audit function, and the need for non executive – independent directors. This is though an area where the problems of a small tightly knit community come into play. In a society where personal friendship is important, the definition of “independent” starts becoming difficult and elusive. At the same time the pool of potential candidates is also small, while, in addition, mechanisms like internal audit are likely not to work so well because of human relationships that are built on personal knowledge of each other and implicit trust.

#### Accountants & Auditors

From its very existence and even before the Enron case, the Commission identified auditors as one of the crucial pressure points in the system since auditors can, through ensuring proper disclosure in the companies accounts, help in achieving “market” supervision. Auditor independence for us was not just a matter of revenue

dependency (as is the case discussed in other places world wide) but one of close personal relations of the auditor with the company's owners. As I mentioned before, a lot of the companies currently listed on the Cyprus Stock Exchange were, upto very recently, private family business. The choice of auditor for these companies was mainly done on the basis of personal friendship of the owners with the auditor and the need to have a "confidante" with which to "discuss" tax matters. Almost by definition then the auditor is not independent. The current effort of the Commission is to pass the message strongly to company auditors that they, now have a much broader responsibility – to the rest of the shareholders. To this extend the Commission is co-operating with the Auditor's Association referring public company accounts to their technical committee for review, while, at the same time, it also refers potential breaches of professional standards to the disciplinary section of the Association. By increasing the potential penalties on Auditors through detection and disciplinary sanctions the commission believes that it will act as a counterveiling power to the personal relations that exist. In addition it has suggested (and was adopted) in the Cyprus Corporate Governance Code that the appointment of auditors, as well on their remuneration be a function of the audit committee (which is in the majority made up by non-executive independent directors but I again stress the problem I mentioned before in finding true independent direction in a small society).

#### Financial Firms and other market intermediaries

The final pressure point that we currently are focusing our attention is to the market intermediaries - the financial firms that provide investment services and stand between issuer and the investing public. The conflicts that exist in such institutions are well known – analyst conflicts, investment banking and fund management conflicts etc etc. By putting heavy duties of care to these firms - be they as promoters of an issue, fund managers etc, one shifts the balance of incentives towards investor protection. Again the trick is to apply the correct level of pressure. Too little has no effect, while too much can lead to paralysis, high compliance costs and in the end expensive services to the consumer. Again the small size of Cyprus Financial Firms makes the problem more difficult. The operation of Chinese walls, the existence of internal audit etc are both difficult to enforce in small entities and more costly.

## DIRECT SUPERVISION

On the other hand there are cases where direct supervision of the market is essential. Economic theory suggests that the fundamental precondition for the existence of financial markets is the belief of investors that markets are fair – that all investors with equal skills have equal chances of winning or losing.

Abusive market behavior – be in the form of market manipulation, the use of inside information to trade, or misinformation by either false rumor spreading or by purposely dressing up company announcements or company accounts or reports, strike at the core of investor confidence and destroy the trust that investors have that they are participating in a fair game, and therefore threaten the very existence of financial markets. I need not dwell on to what this can mean to an economy, the allocation of resources, the cost of capital and economic development.

This kind of abusive behavior is not easily prevented by having one group of market participants watching the behavior of others, through even here a good design of rules & regulations can help (eg rules that require the reporting of suspicious transactions by financial firms, or that prohibit such firms to execute deals that they suspect are based on inside information or that they think are done in order to manipulate the market).

In this area the supervisory function of the Cyprus Securities Commission is more direct, monitoring daily transactions on the stock Exchange for signs of manipulation and/or insider activity. Here the small size of the market and the close society bring their own issues for special consideration.

## Market Manipulation

Volumes on the Cyprus Stock Exchange are quite small and as such the market can be manipulated easily without the need to commit enormous amounts of funds. This weakness is also an advantage since any manipulative behavior can also be easily spotted, while the connections between concerted parties acting in unison are more easily understood because of the close nature of the society where information on “relationships” are common knowledge and do not require huge databases or investigative resources to establish. On the other hand the small market size and the

“natural” response of the market to biggish orders (either upwards or downwards) leads to a lot of false alarms - sudden price increases/decreases that are not the result of manipulative behavior but are genuine responses of the market to increases in demand or supply.

### Insider trading

Similarly insider activity is more easily spotted by an increase in volume prior to important announcements because of the relatively high volume of inside trades that one has to make in comparison with the normal trading volume, if the inside information is to lead to any worthwhile gains. Again the “public” knowledge of relationships due to the small society is a help to the investigator. (The market is very transparent this sense). On the other side of the coin the small society which makes company information more difficult to keep private, also increases the potential number of insiders away from the traditional senior management and directors to almost all the staff of the company and even third parties that have personal friendships with key executives that “spill the beans” during socializing.

### **CONCLUDING REMARKS**

Let me recap what I have been saying so far. The art of capital market regulation is one of balancing direct regulation and supervision on the one hand and on the other designing a system that will work on its own with minimal supervisory effort.

This is brilliantly captured in Alan Greenspan’s “corporate governance” speech at the Stern School of Business in March 2002 from which I quote.

“Before concluding, I should like to emphasize that a market economy requires a structure of formal rules – a law of contracts, bankruptcy statutes, a code of shareholder rights – to name but a few. But rules cannot substitute for character. In virtually all transactions, whether with customers or with colleagues, we rely on the word of those with whom we do business. If we could not do so, goods and services could not be exchanged efficiently. Companies run by people with high ethical standards arguably do not need detailed rules to act in the long-run interests of shareholders and, presumably, themselves. But, regrettably, human beings come as we are – some with enviable standards, but others who continually seek to cut corners. Yet there can be only one set of rules .....and it must apply to all. Crafting the rules to

provide the proper mix of regulatory and market-based incentives and penalties has never been easy. And I suspect that even after we get beyond the Enron debacle, crafting updating such rules will continue to be a challenge”.