CHALLENGES FACED IN EXAMINING THE EFFECTIVENESS OF MARKET INTERVENTION MECHANISMS

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Objectives of today event

- To gain a holistic picture of the range of regulatory interventions available
- Managing market participants expectation: to understand why it is so difficult to measure the effectiveness of regulatory interventions
- What can investors do to protect themselves during the market volatility post regulatory interventions

Common Types of Regulatory Intervention

- Discretionary measures
  - Trading halt
  - Market closure
  - Public query mechanism
- Automatic measures
  - Price limits
  - Circuit breakers

Common Types of Regulatory Intervention

- All market intervention methods are double edged swords
- And their reasons for being so tend to be common

- For discretionary measures
  - The public query mechanism will serve as our case study

- For automatic measures
  - The circuit breakers mechanism will be narrated.

Unusual market activity in APAC

- What is unusual market activity (UMA)?
  - A sudden increase in share price over a short period of time.
  - A sudden drop in share price over a short period of time.
  - A sudden increase in transaction volume over a short period of time.
  - Any of the above combination.
- What is public query mechanism?
  - A public announcement by the financial regulators to alert market participants on the presence of abnormal pricing and/or transaction volume volatility. Listed companies that are issued with public queries must respond within a short time frame whether or not they possess any undisclosed material information that may explain the UMA.
- Aemulus (Malaysia)
  - From its IPO debut on 15th Sep 2015 at an offering price of RM 0.35
  - Share price hit an all time high of RM 0.57 on 1st Oct 2015
  - Magnitude of ascent in that day alone was 14%.
  - Received its maiden public query from Bursa Securities on 1st Oct 2015

Unusual market activity in APAC

- Hanergy (HK)
  - Witnessed two trading sessions of 46.3% spikes in price
  - Both within the time span of just 9 trading days.
  - Reached a peak of HKD 9.07 during the first week of March 2015
  - Before eventually plunging back to HKD 3.91
  - Indefinitely suspended from July 2015 onwards
  - From peak to bottom, it took just four months

- Blumont (Singapore)
  - From SGD 0.79 during the first week of July 2014, it shot up to SGD 2.43 by the third week of September 2014.
  - That is a 200% price increment in around 60 trading days.
  - By mid October, the price crashed to SGD 0.133.
  - In less than a month, all the previous gains were wiped out.

Some questions that market participants always ponder

- Are these unusual market activities more common in Asia?
- Did the financial regulators do anything during these volatile moments?
- If so, what are the regulatory “measures” available?
- Are these “measures” effective?
- Currently, HKEx does not practice the public query mechanism

Is public query suitable for Asia Pacific?

- Prevalence of family ownership in the equity market
- Incentives to extract private benefits at the expense of minority shareholders
- There are numerous examples, including convicted cases
- When both external auditing and the corporate governance framework failed to safeguard market integrity, we would expect a regulatory intervention
- According to Black (2001), regulatory enforcement is particularly effective at protecting investors from expropriation activities.
- In other words, filing lawsuits and imposing large punitive fines on offenders are effective in upholding market integrity.
- Punishing offenders with adequate penalties send out warning signals to would-be offenders that they are being monitored constantly.
- In the case of milder offenses however, lawsuits and fines may be too harsh and inappropriate, whereas private warnings are too light and do not send out any warning signal to the marketplace.
- This is where the public query mechanism fits in:
  - Highlight to market participants that abnormal events are present
  - A platform for listed companies to explain.
  - Dual purposes served.

Golden question

- **Is the public query mechanism useful for market participants**?
- Regardless of whether queried companies eventually provide any explanation, enhanced volatility in stock price is almost certain to occur after public query.
- If the sole aim was to enhance market disclosure, it will always be at the expenses of enhanced stock market volatility
- And if we were to measure the % of instances where companies did eventually revert with additional material disclosures to the query –
  - The result is hardly encouraging at all ….
- Can we then conclude that the public query system is not useful for market participants?
- Not so easy

As a discretionary intervention measure, is the public query mechanism effective?

- First of all, it is not easy to judge.
- Consider if we have 100 cases of unusual market activities
  - Case A: only 2 companies replied that they are aware of what is causing the UMA while the rest of them (98 in total) replied that they are not aware of anything.
  - Can we then conclude that the public query mechanism is a failure?
  - Not really!
  - Simply because there is always the possibility that those 98 companies could genuinely have nothing additional to disclose.
  - Case B: over to the other extreme where 97 companies replied that they are aware of what is causing the UMA and go on to explain in details.
  - Can we then conclude that the public query mechanism is a success?
  - We can't!
  - Simply because there is always the possibility that these 97 companies are merely paying lip service. In other words, they might not be divulging the real reasons that are triggering the UMAs.
- As can be seen, it is getting a bit like the chicken and egg issue
- Not an easy task to formulate an objective research to examine the effectiveness of the public query mechanism.

What are circuit breakers?

- Quoting from a paper released by SFC – "*Circuit breakers are trading halts triggered by sharp price movements. They could be imposed on an individual financial instrument or the market as a whole.*"
- It is important for us to distinguish between "circuit breakers" and "price limits".
- Again quoting from the same paper released by SFC – "*Price limits are maximum percentages or values that a security or derivative contract could rise or fall during a trading day. There is no trading halt and trading can continue within the limit bounds.*"

What happened recently?

- In September, Chinese regulators introduced draft regulation to put in place this mechanism for the Shanghai Composite Index (SSE).
- In December, they announced implementation of it would begin on the first day of trading in 2016.
- On 4 January, the circuit breaker was put to its maiden test.
- The Shanghai Composite Index began its downward descent right at opening bell (09:30 GMT+8).
- At around 13:13 GMT+8, trading was suspended for 15 minutes when prices dropped 5%.
- Upon trade resumption, prices nosedived another 7% in just over two minutes.
- As a result, trading was suspended for the rest of the day.
- SSE's opening day in 2016 was extreme, but 7 January proved even more volatile for the exchange.
- At 10:03 GMT+8, just 33 minutes after the opening bell, trading was halted for the rest of the day after the Shanghai Composite Index nosedived by more than 7%.
- Later that day, Chinese regulators announced that they would suspend the new circuit-breaker mechanism until further notice.
- To date, 7 January is the shortest trading day ever in the 25-year history of the Chinese stock market.
- The CSRC put on hold the circuit breaker mechanism.

Overview of the Circuit Breaker Mechanism

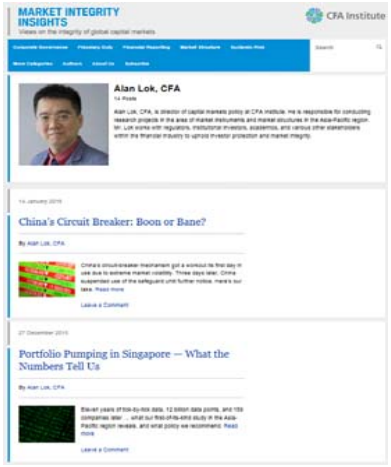
- First of all, results from quantitative analysis conducted in different bourses have diverging conclusions.
  - In a 2004 study undertaken by Tooma and Sourial on the Egyptian stock market, circuit breakers were found to increase investors' risk aversion and magnified distortions to market-price movements.
  - In a 2015 study undertaken by Draus and Van Achter on developed countries' equity market, they concluded that once the circuit-breaker mechanism was fine-tuned and optimized to properly account for liquidity shocks, it did improve market stability and overall welfare.
- Second, supporters of the mechanism argue that:
  - By providing investors with a cooling-off period, it will calm fear and panic during steep market declines.
  - The mechanism limits market volatility and give market participants time to reconsider their positioning.
  - Provides time for increased information flow, and therefore the equilibrium between buyers and sellers restored.
  - Given more time, investors will acclimate to the new mechanism and thereafter a decline in market volatility.
- Third, critics of the mechanism argue that:
  - Circuit breakers drain off liquidity and diminish market depth.
  - They also lament that circuit breakers trap investors in their positions given that they are not allowed to engage in equity transactions that would most probably reflect their assessment of the market situation at that moment.
  - Critics argue that circuit breakers might not be so suitable in a retail-driven market such as China's. Their logic is that when investors are prevented from selling, irrationality and fear will surface, which may lead to more panic selling once trading resumes.

Overview of the Circuit Breaker Mechanism

- Depend which side you are in
  - Are you vested?
- Intent behind financial regulation
  - SFC's mission statement: "… *strives to strengthen and **protect** the integrity and soundness of Hong Kong's securities and futures markets for the benefit of investors and the industry."*
  - CSRC's mission statement: "…*maintains an **orderly** securities and futures market order, and ensure a legal operation of the capital market.*"
  - SEC's mission statement: "…***protect** investors, maintain fair, **orderly**, and efficient markets, and facilitate capital formation*."
  - Definition of orderly function?
  - Definition of soundness?
  - Investor protection – a diverse group, who should we protect?
  - Long run benefits versus short term benefits.

Before moving on to panel discussion

- For those of you who are interested to know more about regulatory issues, please click on the following link to express your comments on my blog articles:
  - https://blogs.cfainstitute.org/marketintegrity/author/alanlok/
  - Alternatively, simply google: “Alan Lok, CFA” to look for the articles I have written



- During the panel discussion, we will be looking at the following:
  - Disclosure from listed companies – is it enough?
  - Regulatory intervention – how much and when would it be justifiable?
  - During abnormal market activities, should regulator step in to inform the public?
  - Circuit breakers – supporters versus critics.
  - Complementary measures that might be useful
  - What can investors do to protect themselves in the current era of volatility?

THANK YOU!