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Post-Crisis Capital Market Reforms in East Asian Economies[#]

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1. Recent Role of Capital Markets in the Presence of Troubled Banking Sectors

Table 1 summarizes investments financed by capital markets and commercial banks in the region prior to and subsequent from the Asian financial crisis. As a percentage of GDP, the incremental amount of credit extended by the banking sector in 1996 ranged from Taipei,China's 2.6% of GDP to Malaysia's 17.9%.¹ However, comparable figures declined drastically in 1999, recording negative figures for most economies with the exceptions of Taipei,China and Korea. Capital market financing increased but it could have increased more. Although long-term bond markets have been discussed as a most important alternative source of financing during the post-crisis period, they have yet to advance. In the region, capital markets are underdeveloped. Bond markets, especially, are illiquid or non-existent and whatever reform measures implemented will take time before they make notable differences for the improved role of capital markets.

[Insert Table 1]

Table 2 summarizes stock market performance both in local currencies and U.S. dollars. Thailand, Philippines, and Malaysia recorded negative returns in local currencies, but not surprisingly, all other economies performed extremely poorly once their market performance is evaluated in U.S. dollars with the People's Republic of China (PRC) and Hong Kong, China as the only exception.

The overall results are not unexpected given the unprecedented financial crisis that hit the region's economy and local currency values. However, a more unsettling observation is the market performance recorded in the first ten months in year 2000. Four economies in the region show the worst performance: Korea (-46.90%), Thailand (-42.60%), Philippines (-41.61%), and Indonesia (-37.90%) even though their economies are supposed to recover from the recent economic recession. In terms of U.S. dollars, the performance measures are even worse: Philippines (-51.82%), Indonesia (-51.05%), Thailand (-50.61%), Korea (-46.78%) and Thailand (-53.23%). One clear message emerging from Table 2 is that the crisis is not completely over yet---at least that's what the region's capital markets perceive.

[Insert Table 2]

Against the backdrop of the Asian financial crisis, the Asian Development Bank (ADB) undertook a study of the financial markets in nine economies in the region to understand structural weaknesses in the region's capital markets and to make policy recommendations for building robust and efficient capital markets.² As the region's banking sector suffered from its own fragility characterized by lax regulatory supervision and poor governance, further development of capital markets emerged as an important policy consideration in the region. Six areas of

¹ Following ADB's member acronyms, Hong Kong is shown as Hong Kong, China and Taiwan will be denoted as Taipei, China.

² The countries studied were five crisis-affected economies, including Indonesia, Korea, Malaysia, Philippines, and Thailand, and four vulnerable economies, including PRC, India, Pakistan, and Viet Nam.

market reforms were identified in the ADB report to address fundamental weaknesses of the region's capital markets:

1. Development of Long-Term Bond Markets
2. Improvement of Corporate Governance Practices
3. Reinforcement of Regulatory and Supervisory Arrangements
4. Expansion of the Investor Base
5. Further Improvement of Equity Market Infrastructure
6. Re-evaluation of Market Volatility-Controlling Mechanisms

As summarized in Appendix A, a total of 23 policy recommendations were proposed for the six areas identified in the ADB report. These recommendations were endorsed by senior-level market regulators from the region who participated in the High-Level Regional Workshop on the Asian Financial Crisis held in Tokyo, Japan on March 25-26, 1999.³ These recommendations serve a useful purpose of benchmarking various on-going reform measures in the region against what should have been and ought to be implemented.

[Insert Appendix A]

II. Long-Term Bond Markets⁴

The Asian financial crisis highlighted two problems of maturity and currency mismatches: Short-term foreign capital cannot finance long-term

³ The Workshop was co-organized by ADB, ADB Institute, and the Institute for Fiscal and Monetary Policy of Japan's Ministry of Finance.

domestic projects. Domestic sources of long-term funds should have been created. With domestic bond markets under- or undeveloped, local corporations borrowed heavily from offshore markets. Especially when the banking sector was forced to undertake drastic reform and consolidation programs, too much dependence on bank financing in the past exacerbated the liquidity problem facing domestic corporations. Naturally, the most important area is the development of domestic bond markets in the region's economies.

Four major impediments to the development of bond markets have been identified by three major studies undertaken by multilateral financial institutions [Organization for Economic Co-Operation and Development (1992), World Bank (1995), and ADB (2000)].⁵ The four impediments cited by these studies include: (i) lack of benchmark yield curves; (ii) restricted supply of quality bond instruments; (iii) limited demand; and (iv) inadequate market infrastructure.

Benchmark Yield Curves: Even before the Asian financial crisis hit the region, Hong Kong and Singapore proceeded with the creation of benchmark interest rates using government-issued securities even though both economies did not need government borrowing due to budget surpluses in the past. Their sole purpose was to create benchmark yield curves for efficient price discovery of all

⁴ This section is an updated version of Section II of Rhee (2000c). This updated version covers the recent capital market reforms implemented through September 2000, whereas the coverage of Rhee (2000c) stops at the end of March 2000.

⁵ In addition, ADB is in the final stage of completing a comprehensive regional level government bond market study and ADB Institute just launched a research project on the development of corporate bond markets as part of its Asia Policy Forum programs.

other fixed-income securities as well as equity instruments.⁶ Without benchmark interest rates, marking-to-market is impossible. Without marking-to-market, portfolio performance must be assessed based on book value of assets, eliminating any incentive for trading and causing the secondary market to be illiquid. In the past, short-term maturities were the norm in the region's government bond markets, which was one of the reasons why risk-free interest rate-based yield curve was incomplete. This problem was particularly severe in PRC, Indonesia, Korea, Malaysia, Philippines, and Thailand. With the exception of PRC and Indonesia, the maturity structure of government-issued securities has lengthened in recent years in the region.

In terms of post-crisis market reforms for the development of domestic bond markets, Korea and Malaysia may be cited as role models in the region. Recent reform measures implemented by Korea include: (i) consolidation of government-issued securities into Treasury bonds to improve the frequency and issue size; (ii) creation of the primary dealer system; and (iii) elimination of arbitrary cut-off in determining winning bids in competitive auctions of government securities. The National Bond Market Committee (NBMC) was commissioned to study how to increase the depth and breadth of the Malaysian debt market. Although detailed recommendations by the NBMC study have yet to be released for public consultation, a series of recent announcements from the Malaysian authorities indicates that a comprehensive program of bond market

⁶ Unfortunately, regular issuance of Exchange Fund papers was substantially curtailed as of September 1998 to strengthen Hong Kong's currency board system, undermining the reliability of the benchmark yield curve.

reforms is in the making. As of July 2000, the Securities Commission (SC) became the sole regulator for all corporate debt securities and the registration of all fund raising activities. This change marked an important step toward an integrated regulatory structure of the Malaysian bond market. In the past, the issuance of bonds was considered as a deposit-taking activity and, hence, it required prior approval of the Bank Negara Malaysia (BNM). Therefore, all new issues of debt instruments must receive BNM approval and then apply for approval from SC, a regulator over capital market. This dual process of approval frequently causes long delay, which in turn, discourages local corporations from using capital market financing due to greater interest rate risk. Striving to be a prudent regulator of the banking sector, BNM uses this approval process to meet its broader monetary policy objectives. Because of its conservative stance toward monetary policy, some critiques argue that BNM's involvement in the local domestic bond market activities stifled the development of corporate debt market [Pardy (1998) and Shimomoto (2000)]. With this change of regulatory structure, the approval of corporate debt issues is expected to take only two weeks, down from three to four months previously.⁷ All corporate debt issues require a credit rating, but a minimum rating requirement for debt securities is no longer necessary.⁸ The SC relaxed the requirement that all debt issues be fully underwritten by financial institutions, which will cut costs for corporate issuers.

⁷ This change does not apply to equity-linked debt securities.

⁸ Previously, debt securities needed a minimum long-term credit rating of triple B and a short-term rating of P3/Marc3.

Limited Demand for Bond Instruments: The limited demand for fixed-income securities in the Asian economies should be attributed to the captive nature of the primary markets in the presence of administered interest rates. One example is noted from PRC. To minimize competitive pressure on Treasury issues, Nam, Park, and Kim (2000) report, the Chinese government stipulates that yields on state-owned-enterprise (SOE)-issued bonds can not exceed those on Treasury bills and they can not exceed 1.4 times those on bank deposit rates.

Even after interest rates were deregulated, the primary market yields of government bonds may fail to reflect credit market conditions because of the manner competitive auction systems are managed.⁹ Rhee (2000a) identifies that the captive nature of primary market activities is evidenced even in Singapore where the current status of market development is far ahead of other economies in the region: the Central Provident Fund (CPF) holds approximately two-thirds of Singapore government securities (SGSs) by the end of 1999 and the SGSs placed with CPF are considered non-tradable and bypass the primary dealer network to avoid any adverse effect on primary market yields. Similar arrangements are observed with Malaysia's Employee Provident Fund investing over 50% of its investible funds in Malaysian government securities (MGSs). Artificial demand for government-issued securities under such regulatory requirements tend to distort the yield curve.

⁹ Prior to the Asian crisis, Korean government bonds were issued using a "competitive" bidding method that awards the bids in the order of the lowest to the highest yields. However, the highest yields must be lower than the rate set by the Korean government. If the total award is lower than the total planned issue, then the syndicate is obliged to buy the rest at an annual yield which is 0.1 percent lower than the average yield of successful bids. As the pre-set rate is lower than the market interest rate, the primary market yield fails to reflect the conditions in the credit market.

Observed in the region are some positive developments toward increasing the demand for government-issued securities from individual investors. First, the Philippines introduced a small denomination Treasury bonds (SDTs) program for individual investors. The intention of having SDTs listed on the Philippine Stock Exchange is to provide liquidity support for individual investors. Second, the Exchange Fund Notes (EFNs) have been listed on the Stock Exchange of Hong Kong (SEHK) since August 1999 to accommodate retail investors' demand for risk-free securities. The listing of EFNs on the organized exchange is an important experiment of involving individual investors in the traditionally institution-dominated market, which will be observed carefully to assess how it evolves. Third, Hong Kong, China is launching a Mandatory Provident Fund in December 2000 intended to increase the demand for local long-term fixed-income securities by approximately 1% of GDP per year consecutively for six years. Fourth, effective March 2000 in Korea, bank trust accounts have been allowed to sell employee retirement trusts, which is a first step toward the corporate pension system.¹⁰ In the past, individual investors were not eligible to make direct purchase on the primary market in Korea, but they are qualified to participate in non-competitive auctions effective September 1999. Now, a total of 20% of each primary issue is reserved for individual investors. In contrast, the current tax system in Singapore discriminates against individual investors. While

¹⁰ Corporate pension funds are at an embryonic stage in Korea. Corporations maintain corporate pension funds, but they are not separate accounts devoted for the purpose of investment. Rather, these funds are at the discretion of the employers as to how they are managed. Refer to Korea Securities Research Institute (2000).

a concessionary tax rate of 10% on interest income was granted to local corporations in 1998, no such incentives are available to individual investors.

Limited Supply of Quality Bond Issues: In the past, Singapore's statutory boards never issued their bonds since government budget or commercial bank loans were readily accessible. With the change of this policy in the fourth quarter of 1998, a number of government agencies (Housing Development Board, Land Transportation Authority, Jurong Town Corporation) began to issue long-term bonds. The total issuance of such bonds amounted to S\$2.3 billion; however, this amount will increase as 44 government agencies exist in Singapore.¹¹ Singapore's government agencies are also encouraged to seek rating of their bonds to be issued.

The Malaysian government recently proposed the establishment of a financial guarantee insurer (FGI) to facilitate the issuance of corporate bonds. The FGI will provide the issuer with a guarantee facility to enhance the rating of the issues. For private sector corporations facing economic recession, FGI is a sensible option to explore. Thailand's state-owned enterprises became major suppliers of high-quality bonds (almost 90% of their bonds are issued under the government's guarantee), accounting for slightly over one-third of public sector bonds. However, the secondary market activities are limited because those bonds guaranteed by the government are eligible for reserve requirements.

As part of the banking sector restructuring, Malaysia established two government-owned corporations, Danamodal Nasional Bhd. to facilitate

¹¹ Refer to Tan (2000).

restructuring of financial institutions and Pengurusan Danaharta Nasional Bhd. to acquire non-performing assets from financial institutions. Both companies issued five-year bonds of M\$11 billion (Danamodal) and M\$10.3 billion (Danaharta), respectively. However, their impact on the development of the domestic bond market was minimal since these bonds were mostly assumed by financial institutions and they were eligible for reserve requirements.

Likewise, the Indonesian Ministry of Finance commenced the issuance program of bank recapitalization bonds in 1999. As of March 2000, the total amount of these bonds issued reached Rp. 510.1 trillion and this amount is expected to reach Rp. 653.7 trillion by the end of 2000. Despite the magnitude of government bonds issued, its impact on the secondary market is insignificant because the Indonesian government only allotted a mere 10% of bank recapitalization bonds eligible for trading.

Bond Market Infrastructure: Given the current stage of market development in the region, two most important infrastructure issues are: (i) the adoption of competitive auction system; and (ii) the creation of clearing and settlement system. Even the Japanese government bond market, which is the largest in the world in terms of outstanding amount, is slow in adopting a truly competitive auction system.¹² At present, more than one-half of Japanese government bonds are issued on a non-competitive basis largely through syndicated underwriting. With government-managed pension funds and financial institutions serving as the largest buyers of government bonds, PRC, Malaysia, Singapore,

¹² Refer to Rhee (2000b).

Taipei,China adopted both competitive and non-competitive issuance methods. Korea is increasing the portion of auction-based issuance. Indonesia has yet to adopt competitive auction methods for future issuance of government bonds.

The region's economies rely on multiple-price auction methods among participating primary dealers; whereas, the U.S. Treasury no longer uses the multiple-price auction methods in preference to the uniform-price auction method since November 1997 because of its concern about the "winner's curse."¹³ To improve the efficiency of tendering and to reduce any delays, the electronic bidding system has been introduced in Malaysia, Philippines, and Korea.

A substantial amount of integration and coordination has to be done to offer efficient clearing and settlement systems in the region. Clearing and settlement systems have been developed by central banks in the region to facilitate open market operations and interbank trading for government bonds; however, clearing and settlement of corporate bonds remain underdeveloped. The Hong Kong Monetary Authority (HKMA) developed the Central MoneyMarkets Unit (CMU) in 1990 for the clearing and settlement of Exchange Fund Bills and Notes as well as some private sector debt instruments. With the trading of Exchange Fund Notes on the SEHK, all trades are settled through the existing Central Clearing and Settlement System (CCASS) of the SEHK with a linkage established between CMU and CCASS. In Thailand, however, trades on the Bond Dealing Centre are settled through the Stock Exchange of Thailand's

¹³ The "winner's curse" is introduced under the multiple-price auction method because successful bidders pay the prices they bid. As a result, the highest bidder wins the auction by paying the highest price, only to find that another bidder pays a lower price, whereas all successful bidders pay the same price for a given security under the uniform-price auction method.

clearing mechanism. Singapore government securities trades are cleared through the Singapore Government Securities Book-Entry System maintained by the Monetary Authority of Singapore. In 1998, the Central Depository (Pte) Ltd., a subsidiary of the Stock Exchange Limited, introduced the Debt Securities Clearing and Settlement System, an electronic book-entry system for the custody and settlement of corporate bonds. As clearing and settlement systems for corporate bonds are being developed in each of the region's economies, one important policy question must be addressed: Should a single clearing and settlement system be developed for both government bonds and corporate bonds or should two separate systems be developed?

Hong Kong, Malaysia, and Singapore introduced a real time gross settlement (RTGS) system for government-issued securities, while corporate bonds need to advance toward the level of progress made for clearing and settlement of government bonds. Korea, Taiwan, and Thailand are revamping their systems for corporate bonds. Taiwan implemented a book-entry system for scripless trading in 1998 and all book-entry government bonds are settled through the RTGS system.

Although fixed-income securities are traded over-the-counter (OTC) in the region, some interesting developments are noted because organized exchanges created trading systems to capture market share of OTC trading volume. The Korea Stock Exchange (KSE) recently made a serious effort to reclaim some of OTC trading volume by organizing two organized bond markets: general bond market, a retail market for individual investors, and inter-dealer market, an

electronic wholesale market for institutional dealers. The success of this attempt is too early to assess, but it may serve as an experimental model for other exchanges in the region if this trial becomes successful. Recently, the Korean government licensed a private institution to become an inter-dealer broker in competition with the KSE's IDM. In Thailand, BDC was upgraded to an organized exchange to facilitate secondary market activities. The BDC was instrumental in formalizing OTC activities and disseminating pricing information and statistics. In Indonesia, the Surabaya Stock Exchange introduced an OTC Fixed-Income Service to support fixed-income securities trading in 1997. As organized exchanges transition into the territory of OTC markets, an interesting policy issue emerges---how would an organized exchange interact with inter-dealer brokers who provide specialized trading facilities in fixed-income securities? Given the recent trend in internet trading, a multiple number of inter-dealer brokers are expected to compete in the bond market. In alignment with this trend, therefore, regulatory bodies in the region should promote competition in trading services rather than giving monopoly power to an organized exchange.

III. Corporate Governance

In the region's bank-based financial system, both internal and external monitoring of management decisions is either lacking or inadequate, if existing at all. Internal monitoring has not been effective because ownership and management are not fully separated. Mergers & acquisitions and the creation of a legal and institutional framework for the protection of creditors and outside shareholders are the proper vehicles for enhancing external monitoring.

Economic developmental policies adopted by the region's economies did have negative side effects on corporate governance. It promoted subsidized bank lending, encouraged over-investment, and over-borrowing. The banking sector in general became inefficient in its monitoring functions while accommodating the government's industrial policy in its lending decisions. Additionally, small and medium size enterprises had the limited access to bank credit.

To strengthen both internal and external monitoring within an adequate legal and institutional framework, comprehensive reforms are needed. The reforms must: (i) ensure competitive capital markets (especially for corporate financing), with minimal government interference; (ii) provide solid legal protection for investors (shareholders and creditors); and (iii) define and enhance the role of outside shareholders.

Two most remarkable improvements are observed throughout the region in two major areas: (i) corporate governance structure; and (ii) corporate disclosure system. For example, Korea's recent changes in corporate governance may represent a good example.

Appointment of Outside Independent Directors: The KSE's listing requirements were amended so that at least one-quarter of the board of directors will be filled by outside, independent directors beginning in 1999. An outside director must meet the pre-defined standards and must possess sufficient professional knowledge and experience in management, economics, accounting, law or related fields. Although such an appointment is recommended rather than legally imposed, the KSE made it possible that non-compliance could lead to delisting.

Traditionally, Korea's corporate board system is characterized by a unitary board system, following the US and UK models.¹⁴ The Kuala Lumpur Stock Exchange (KLSE) also set restrictions on company directorships: a director of a listed company is not allowed to hold more than 25 directorships, 10 in listed companies and 15 in other companies.¹⁵

Protection of Minority Shareholders' Rights: From April 1, 1998, regulations related to the rights of minority shareholders have been strengthened in Korea as shown in Table 3. Similar measures were adopted by the region's economies.

[Insert Table 3]

Allowance of Hostile Takeovers: To allow hostile takeover activities on the secondary market, the mandatory tender offer system was abolished. Previously, shareholders wishing to hold 25% or more of outstanding shares were obligated to acquire them through tender offer. The number of shares for tender offer needed was more than 50% of outstanding voting shares, which made it impossible for any hostile takeovers.

In addition, limitations on stock repurchase and voting rights of institutional investors were lifted. Most importantly, no restrictions are imposed on foreign ownership except for designated "public" corporations. Previously, foreign

¹⁴ Multiple board model is common in Japan and Germany. Under this model, two-tier boards are in existence: (i) supervisory board which is responsible for monitoring and inspecting the operations of the management; and (ii) operating board which assists the management for its business decisions.

¹⁵ Approximately 4000 people are holding more than 25 directorships in Malaysian companies, with 10 people holding more than 10 directorships in listed companies.

ownership was allowed up to 1/3 of outstanding shares subject to approval of corporations.¹⁶

Under the initiative of the Thai Securities and Exchange Commission (SEC), a report (1999), entitled “Enhancing Good Corporate Governance of Thai Listed Companies,” was prepared to make numerous recommendations that may be adopted on a voluntary basis by Stock Exchange of Thailand (SET)-listed companies. The report covers structure of corporate board, protection of minority shareholders’ rights, and financial disclosure and transparency. The SET even launched the Institute of Directors in October 1999 to promote sound governance practices. This Institute serves as a forum to promote awareness of the roles and responsibilities of company directors as well as raise their professional standards, skills, and knowledge to uphold international standards. A similar effort was made by Malaysia through utilizing the KLSE’s Research Institute of Investment Analysts to launch director accreditation programs. The Malaysian SC spearheading necessary amendments to the KLSE’s listing requirements to reflect recommendations on corporate governance by the Finance Committee.

The second area of significant improvement is corporate disclosure and transparency. As the timeliness of the release of corporate information and the information content are two major concerns for market regulators and organized exchanges, many positive changes and improvements on corporate disclosure on the primary and the secondary markets. The Malaysian SC, for example, amended its Policies and Guidelines on the Issue and Offer of Securities. These

¹⁶ For an excellent summary of recent developments in Korea’s corporate governance practices, see Choi (2000).

changes are consistent with its emphasis on disclosure-based regulatory philosophy. In return for liberalizing the requirements on pricing of securities, valuation of assets and utilization of proceeds, the SC reinforced disclosure obligations of issuing corporations. As a consequence of this new approach, new activity has occurred in the area of accounting standards and reporting requirements. In 1999, the KLSE also introduced a requirement for quarterly reporting by listed companies that would be mandatory for all public listed companies with quarters ending in July 1999.¹⁷ In addition, they are also required to release their annual audited accounts, auditors' reports, and directors' reports within 4 months from the end of a financial year. To facilitate efficient and timely dissemination of announcements and other information by listed companies, KLSE introduced the KLSE Link, a centralized web-based system, to automate archiving, retrieving, and disseminating of corporate information in October 1999. Similar web-based disclosure systems were also launched by KSE and SEHK. Singapore is stiffening the relevant laws on financial disclosure: it is now a statutory obligation for companies to provide timely and complete

¹⁷ SEHK is considering shortening the reporting period for financial results and possibly requiring quarterly results. A table below contrasts financial disclosure requirements between Hong Kong and New York Stock Exchanges:

Publication Of _____	Hong Kong		New York
	Current	Proposed	
Annual Results	5 months	3 months	90 days
Six-Month Results	3 month	2 months	45 days
Quarterly Results	n.a.	Under review	45 days

Source: SEHK Market Consultation Policy Paper on Financial Disclosure (1998)

disclosure. Failure to do so will no longer be just a breach of stock exchange rules but will also result in a judicial penalty.

IV. Regulatory and Supervisory Arrangements

Rhee (2000a) identifies the following weaknesses in regulatory and supervisory arrangements in the region: (i) fragmented regulation; (ii) merit-based regulatory approach; and (iii) underutilization of self-regulatory organizations (SROs) prior to the Asian crisis.

Fragmented Regulation: Positive developments have occurred in recent years to remedy the problem of fragmented regulation in the region. Korea created the Financial Supervisory Commission (FSC) which now oversees four major functions: securities, banking, insurance, and credit management fund. In Malaysia, the regulatory structure among the BNM, SC, and Registrar of Companies has been streamlined to avoid overlapping responsibilities in the approval of private debt securities. The Thai SEC emerged as a more independent and autonomous market regulator after the crisis, integrating both licensing authority (transferred from the Ministry of Finance) and monitoring and supervising authority over capital market institutions. In PRC, the Securities Law was put into operation as of July 1999, consolidating the numerous regulations, rules, directives, and guidelines that have existed since the creation of the domestic capital markets almost nine years ago in Shanghai and Shenzhen. Especially, this Law represents an important milestone in capital market regulation in PRC because it eliminates functional fragmentation between the central bank, China Securities Regulatory Commission (CSRC); and other

government departments. A slow progress is noted in correcting the weaknesses in the regulatory and supervisory processes of the Philippine SEC. First, the main problem of the SEC is the vast responsibilities which include company registration, arbitration of company disputes, and involvement in insolvency procedures, in addition to its normal capital-market functions [Rhee (2000a)]. Second, its regulatory coverage is not clearly defined vis-à-vis the Philippine Stock Exchange, which causes public confrontation between the organizations on daily operational issues such as daily price limits and trading suspension.

Indonesia's market regulatory arrangements also will benefit from significant improvement. Its regulatory framework is structured by the Capital Market Law of 1995. Capital market policies are formulated by the Minister of Finance and the Capital Market Supervisory Agency (BAPEPAM) is responsible for the implementation of these policies. As a unit of the MOF, the BAPEPAM's Chairman reports to the Minister of Finance; and, the BAPEPAM's operation is funded by the government budget. Based on the Capital Market Law of 1995, the BAPEPAM issued a series of rules and regulations. These rules and regulations range from licensing, registration, and supervision of capital market institutions (including stock exchanges), initial public offering processes to criminal investigative procedures, law enforcement, and administrative sanctions. Under the current legal framework, the BAPEPAM is a very powerful regulatory agency over the local capital market because all the rules and regulations are drafted by BAPEPAM. Unlike market regulatory agencies in other countries, no board of commissioners is in place as a sounding board for the chairman of

BAPEPAM because it is a part of the Ministry of Finance. In addition, the BAPEPAM approves an annual budget and profit utilization plan of each of major capital market institutions, including the Jakarta Stock Exchange, Surabaya Stock Exchange, and other capital market institutions. The BAPEPAM also strongly influences the selection and appointment of directors of these institutions. Although all these institutions are privately owned SROs, their autonomy is questioned because their budget and personnel decisions controlled by the BAPEPAM. All of these SROs must be granted self-regulatory status with autonomy and independence. The legal status of BAPEPAM, however, may be a critical factor in converting the SROs to truly autonomous organizations. As long as the BAPEPAM is under the direct control of the Ministry of Finance, it may be impossible for BAPEPAM to provide complete independence to various SROs. Hence, BAPEPAM's independence and political neutrality must also be guaranteed before various SROs are granted independence. Given the current regulatory practices in Indonesia, the following changes are desirable:

- Operational decisions for the secondary market (including budget and personnel decisions) should be left with stock exchanges and other capital market institutions to respect their autonomy and independence, while the BAPEPAM continues to be in charge of the primary market-related activities.
- The BAPEPAM should also be changed to an autonomous market regulator independent of the Ministry of Finance.

- BAPEPAM's operational budget should be fully supported by securities transaction fees rather than government budget.
- Governance of BAPEPAM must be redesigned to ascertain its political independence and neutrality.
- A board of commissioners should be created as a policy-making body and more than one-half of the commissioners must be recruited from the securities industry.

De-emphasis of Merit-Based Regulation: The Monetary Authority of Singapore should be commended for its effort of de-emphasizing the merit-based regulatory philosophy among capital market regulatory authorities in the region. An alternative to the merit-based approach is disclosure-based regulation which is based on the principle that the market rather than the regulator is best equipped to decide the merits of a transaction. Investors must take responsibility for their own investment decisions and are not protected from poor judgments. Responsibility for compliance is left to market participants, especially securities market institutions. As indicated in Box A, the disclosure-based regulatory approach was strongly advocated in the ADB's policy recommendation. This approach has been accepted by virtually all regulatory authorities of Hong Kong, China, Indonesia, Korea, Malaysia, Philippines, Thailand, and Taipei,China. This approach is timely because all financial disclosure-related improvements

implemented by the region's stock exchanges are facilitate the change of the regulatory philosophy.¹⁸

Self-Regulatory Organizations: SROs represent an effective vehicle to promote the spirit of market-based self-regulation among private sector capital market institutions. Their role is crucial in achieving financial disclosure among member organizations, in reducing regulatory costs, and in eliminating the problem of moral hazard between the regulators and the regulated. Regulation of a securities market and the financial services industry is one of the most resource-intensive endeavor for the market regulators. Detailed regulatory tasks on a day-to-day basis can be readily delegated to SROs to provide more room for market regulators for regulatory oversight and monitoring. The importance of SROs and their roles appear to be well-recognized by the region's market regulators and so that the delegation of authority is carried out even in regulation-intensive economies in the region.

V. The Investor Base

Despite the rapid growth of equity markets in the region, the investor base has not been broadened. To stimulate market activity on the demand side of the capital markets, ADB recommendations on the expansion of the investor base focused on the creating and strengthening a viable and effective community of institutional investors such as contractual savings institutions, including pension funds, mutual funds, and insurance companies. Despite their vital role,

¹⁸ For example, refer to a keynote speech entitled, "The Malaysian Capital Market-The Way Forward, " delivered by Mr. Ali Abdul Kadir, Chairman of the Malaysian Securities Commission at the Malaysian Capital Market Summit 2000 held on 12 June 2000 in Kuala Lumpur.

contractual savings institutions played an insignificant role in mobilizing savings and developing capital markets in the region. During and subsequent to the Asian financial crisis, the development of contractual savings institutions has not received as high a priority as the banking sector restructuring. As a result, the progress with contractual savings institutions has been slow and tentative.

For example, PRC, Korea, Indonesia, Philippines, Thailand need to establish a social security retirement system. The Asian concept of “family-support” is no longer prevailing among younger and more independent generations. While public sector and private sector pension systems are in place in the region’s economies, various structural weaknesses hinder further development of these funds as significant market forces: (i) accounting method based on the “cost” method of asset valuation rather than marking-to-market; (ii) government-dictated asset management; (iii) limited portability due to tax treatment; (iv) poor design of the pension system; (v) abuse of pension assets by employers; and (vi) the lack of professional fund managers.

Little progress has been reported in the region in designing new mandatory social security retirement systems and improving public sector’s existing provident funds and private sector’s pensions funds. A number of areas must be carefully studied, including: taxation, management of pension assets, benefit packages, fiscal implications, regulatory structure, and creation of an independent agency devoted to the development of integrated social security system, pension and provident funds. Any further delay in rectifying existing

weaknesses of the current system in the region will become very costly and will be a drag in developing capital markets.

Both open-ended and closed-ended investment companies finally emerged in the region as a viable group of institutional investors. For example, PRC allowed finance management companies of large-sized SOEs to invest in stocks and bonds beginning in July 2000. The companies were also allowed to issue medium-term and long-term bonds. It appears that the new rules were intended to strengthen financial conditions of SOEs and promote their competitiveness in the financial services industry ahead of PRC's expected ascension to the World Trade Organization membership. The registered capital of finance management companies was increased from 300 million yuan from the previous level of 100 million yuan and they are allowed to invest up to 20% of that capital in long-term securities investments. At present, there are 69 large-sized SOEs with finance management companies under their umbrellas. An informal estimation indicates that these SOEs have total registered capital of 20 billion yuan and manage total assets of around 200 billion yuan. At present a total of 263 investment companies (81 closed-end companies and 182 open-ended mutual funds) are operating with a combined net asset value of 359 billion baht (or US\$8.78 billion), which compares with 205 investment companies (92 closed-end funds and 113 mutual funds) with net asset value of 247 billion baht (or US\$9.64) in 1996.

Singapore's CPF recently approved dozens of mutual funds in which Singaporeans can choose to invest part of their retirement savings. Although

only one-third of CPF's 1.2 million members hold CPF Investment Scheme accounts, the designation of additional mutual funds may stimulate individual investors' participation in the local market.

VI. Equity Market Infrastructure

Clearing and Settlement: The region's organized stock exchanges have been paying attention to the enhancement of clearing and settlement systems and the implementation of delivery-versus-payment to align with international standards. For example, Malaysia adopted a T+3 settlement cycle for all trades on the KLSE and the Malaysian Exchange of Securities Dealing and Automated Quotation (Mesdaq) by the end of the year. Currently, trades on KLSE and Mesdaq are settled five days after the trade date. With the introduction of the Institutional Settlement Service in August 1999, Securities Clearing Automated Network Services (SCANS), which functions as the clearinghouse for securities traded on KLSE and Mesdaq, has extended its membership to include custodian banks and institutional investors. Hong Kong still lags behind other markets in transforming to a scripless market. While less than one-half of Hong Kong trades are currently conducted on a scripless basis, the Hong Kong Securities and Futures Commission indicates that the implementation of scripless trading will be completed within a two-year period. The clearing system in PRC is based on the paperless depository and high-efficient Legal Person Clearing System with a T+1 settlement cycle.

Under the Capital Market Law of 1995, two financial intermediaries were created. The Indonesian Clearing Guarantee Corporation (KPEI) was established

to provide guarantees against any payment shortfalls subject to availability of clearing funds. The Central Securities Depository (KSEI) facilitates the settlement of transaction by delivering and receiving physical securities certificates at present, but will eventually facilitate scripless trading. In Indonesia, scripless trading is being introduced in phases beginning in July 2000.¹⁹

Brokerage Commission: A more recent development is the deregulation of brokerage commissions to align with a global trend. As of October 1999, brokerage commissions in Japan were liberalized as part of its Big Bang financial reform programs and Korea switched to a freely negotiable system as early as 1995.²⁰ Malaysia will proceed with the deregulation plan in two stages. In stage 1, which takes effect September 2000, commission rates for all trades above M\$100,000 will be fully negotiable. Trades with contract values less than M\$100,000 are subject to a fixed rate of 0.75%. In stage 2, which takes effect July 2001, commission rates will be fully negotiable for all trades, subject to a cap of 0.70%.²¹ Hong Kong is proposing to change from negotiable commission rate with the minimum of 0.25% to a freely negotiable without any ceiling, while Singapore's trades will be completely negotiable beginning in October 2000. Likewise, SET will implement its liberalization plan of brokerage fee effective

¹⁹ Initially, scripless trading of shares of four listed companies is implemented.

²⁰ The average commission rate is 0.41% of the transaction value. See 1999 Factbook of the KKSE.

²¹ The SCANS clearing fee, the SCORE (System on Computerised Order Routing and Execution) fee and the SC levy, which form part of transaction costs, will also be reduced. The SCANS clearing fee will be reduced from 0.05% to 0.04% with effect from 1 July 2001, subject to a maximum of RM200 per contract, while the SCORE fee will be reduced in two stages to 0.005% and 0.0025% with effect from 1 September 2000 and July 1, 2001 respectively. The SC levy will also be reduced to 0.015% from the present 0.02% with effect from 1 July 2001.

October 2000. As a result, PRC and Taipei,China are only two economies with fixed commission rates: a single rate for PRC (0.35%) and a sliding-scale for Taipei,China (ranging from 0.1% for large trades over NT\$150 million to 0.1425% for small trades less than NT\$10 million). Commission rates are negotiable with a maximum ceiling for Indonesia (max 1%) and Philippines (max 1.5%). A quick summary of brokerage commission in the region's capital markets is presented in Table 4.

[Insert Table 4]

Trading Method: All Asian equity markets adopted order-driven systems that do not require market-making functions of market makers unlike quote-driven markets of London and Nasdaq. Order-driven systems use either either the call-market or the continuous-auction method of trading or a combination of both. In the call-market method, orders are batched for execution at a single price to maximize the number of shares traded. In the continuous-auction method, orders are executed whenever submitted bids and offers cross during a trading session. Stock exchanges in Hong Kong, China, Indonesia, and Singapore have been using the continuous-auction method throughout the trading day, whereas stock exchanges in Malaysia and Taipei,China use the call-market method for price and order matching. Exchanges in the PRC, Korea, the Philippines, and Thailand use the call-market method to open a trading session like the New York Stock Exchange and the Tokyo Stock Exchange.²² Chang, Hsu, Huang, and Rhee (1998) compile empirical evidence that demonstrates the advantage of the

²² Korea uses the call-market method to determine closing prices.

call-market method over the continuous-auction method. Interestingly, Singapore adopted the call-market trading method to determine both opening and closing prices beginning in August 2000. Another interesting development the recent resolution of SET board of governors approving a pilot project of a market maker system for a period of six months.²³ Under this pilot scheme, SET will select about 30 - 40 listed stocks of medium liquidity and of market-making interest to member companies. The designated market-maker will have the responsibility of disseminating research findings and promoting interest in the assigned securities. In addition, he will conduct market-making functions. Since many listed stocks on the region's stock exchanges suffer from a severe non-trading problem, SET's pilot program will be of strong interest not only for SET and SEC but also for academic researchers. Another possibility is introduce a call-market trading method in the mid-day to take advantage of batch-processing as is done in Italy's Milan Stock Exchange rather than applying it at the beginning of the morning trading session.

Financial Derivatives: A lack of adequate financial derivative instruments for risk hedging was blamed for the large capital losses suffered by many individual investors during the market downturn, especially during the Asian financial crisis. Equity derivatives such as index options and futures and individual stock options have yet to be introduced in PRC, Indonesia, Philippines, and Thailand.

VI. Reevaluation of Market Volatility Controls

As extreme inter- and intra-day price volatility is a matter of concern to capital market regulators, a number of volatility-controlling mechanisms have

²³ Refer to the Press Release by SET dated September 21, 2000.

been introduced in the region: (i) margin regulations; (ii) circuit breakers; (iii) price stabilization funds; and (iv) securities transaction taxes. Some of these mechanisms, however, are not in use in the U.S. market. For example, the U.S. Federal Reserve Board stopped using margin requirements since 1974 even though margin regulations were initially introduced in 1934 after the 1929 market crash.²⁴ In contrast, some Asian countries (such as PRC, Japan, Korea, Malaysia, Thailand, and Taipei,China) change margin regulations frequently with the belief that they can moderate price volatility. Daily price limits are another example that is no longer in use on the U.S. equity markets, whereas many Asian markets (PRC, Korea, Japan, Malaysia, Philippines, Taipei,China, and Thailand) rely on daily limits to control market volatility.²⁵ Academic research on daily price limits and trading halts (triggered by the organized exchanges or at the request of listed firms) show little evidence in support of a hypothesis that trading halts reduce “noise” trading by facilitating information transmission or a hypothesis that price limits decrease volatility, counter overreaction, and do not interfere with trading activity.²⁶ As result, numerous academic studies question the efficacy and adequacy of various volatility-controlling mechanisms.

Direct market intervention by the government of Hong Kong, China in August 1998 was a most controversial subject of debate during the Asian financial crisis. Hong Kong, China spent HK\$118 billion (US\$15.2 billion) to

²⁴ Refer to Hardouvelis (1988, 1990), Hardouvelis and Peristiani (1990), Hsieh and Miller (1990), and Salinger and Schwert (1989) on the pros and cons of margin requirements.

²⁵ Hong Kong, China, Indonesia, and Singapore do not use daily price limits.

²⁶ Refer to Lee, Ready, and Seguine (1994) and Kim and Rhee (1997).

purchase approximately 7.3 percent of all Hang Seng Index component stocks. According to HKMA, the intervention was not intended to prop up the stock and futures markets. Rather it was targeted at a “double play” by speculators (including hedge funds) that took advantage of the automatic adjustment mechanism in the currency board system of Hong Kong, China. Taipei, China relied on a stabilization fund contributed by government pension and insurance funds, the postal savings system, and state-owned corporations during the Asian crisis.²⁷ Although long-term cost and benefits of stock market stabilization funds remain unknown, this type of market intervention adds more uncertainty to investors. The Hong Kong Tracker Fund is the by-product of market intervention by Hong Kong, China. To minimize the market impact of selling purchased stocks, the Tracker Fund was created as a collective investment fund designed to track the performance of the Hang Seng Index. Its concept is similar to the SPYDER on the American Stock Exchange. Although initial public offering of the Tracker Fund was successful, recording a 3-time over-subscription, this success does not justify the market intervention by the Government. Rather, what the Hong Kong Government did was perceived as an evidence of weakness in its currency board system. The deterioration of financial conditions of Korea’s investment trust companies is largely attributed to government-dictated trading activities to control market volatility.

²⁷ This type of market intervention using stock market stabilization funds is not new in this region. The Korean and Thai governments also employed an indirect method of market intervention by setting up stock market stabilization funds with contributions from securities companies, insurance companies, banks, institutional investors, and listed companies in the early 1990s.

A recent announcement by PRC brings up another unusual measure of investor protection funds. PRC's market regulators (CSRC and Ministry of Finance) will set up two risk management funds of one billion yuan (\$120.8 billion) each to offset small investors' losses. Two stock exchanges and clearing companies have been ordered to divert part of their income and membership fees to establish the two funds, while very little is known how these funds will be managed and how investors' losses are compensated. It is very puzzling how these funds will help stabilize the market.

Schwartz (1988) proposed an interesting idea to reduce excessive short-term price volatility. His recommendation is that listed companies buy (or sell) a given amount of stocks if the stock price declines (or increases) by more than a certain percentage without government intervention. Although the advisability of involving listed companies in market making in such a manner is subject to debate; however, it appears that Taipei, China is following this idea. Taiwan's Parliament passed a bill in July 2000 allowing listed companies to buy back their own shares on the market when their prices drop to unreasonable levels. Such levels may be decided according to set criteria or special rulings by the Ministry of Finance. This will create a "treasury stock" system under which companies would be able to hold their shares for use in issues of warrants or convertible bonds—making such issues much easier than before. Unfortunately, very little empirical work has been done to draw any meaningful conclusion on the role of stabilization funds in moderating price volatility.

Tobin (1979) and Stiglitz (1989) who are proponents of a securities transaction tax point to its beneficial impact of reducing price volatility by discouraging noise traders from active participation in the market. However, more recent evidence reported by Roll (1989), Umlauf (1993) and Hu (1998) does not support the hypothesis that transaction taxes can reduce noise trading and price volatility. One lesson from academic research findings is that market volatility controls are not particularly helpful in moderating volatility. Such controls must be carefully re-evaluated before they are introduced.

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Table 1
Investment Financed by Capital Markets and Banking System

Unit: % of GDP

	1996			1999		
	<u>Equity</u>	<u>Bond</u>	<u>Bank</u>	<u>Equity</u>	<u>Bond</u>	<u>Bank</u>
Hong Kong	8.4	0.1	17.7	12.0	0.3	-7.1
Korea	1.3	3.6	17.7	8.5	-0.6	1.9
Malaysia	6.3	5.7	17.9	1.9	1.7	-0.9
Singapore	2.4	1.8	14.0	1.9	2.1	-3.1
Taipei,China	0.8	0.1	2.6	0.5	-0.2	4.4
Thailand	2.1	1.1	9.8	5.3	4.8	-3.9

Source: Far Eastern Economic Review (July 27, 2000)

Table 2
Asian Stock Market Performance

<u>Country</u>	<u>Annual Return</u> <u>(1995 - 1999)</u>		<u>10-Month Return</u> <u>(Jan-Oct 20, 2000)</u>	
	<u>LC</u>	<u>US\$</u>	<u>LC</u>	<u>US\$</u>
China	16.10%	16.56%	50.78%	50.78%
Hong Kong, China	11.84	11.76	-13.73	-14.01
Indonesia	7.56	-14.78	-37.90	-51.05
Korea	0.01	-6.98	-46.90	-46.78
Malaysia	-3.51	-10.89	-4.10	-4.09
Philippines	-5.11	-14.17	-41.61	-51.82
Singapore	2.06	-0.69	-22.42	-25.98
Taipei,China	3.47	-0.11	-36.03	-37.61
Thailand	-18.74	-25.04	-42.60	-50.61

Source: FIMA Research Center, University of Hawaii

Table 3
Corporate Governance Reform Measures (Korea)

<u>Legal Actions</u>	<u>Before</u>	<u>After</u>
Derivative Suits	1% (0.5%)*	0.05%
Dismissal of directors or auditors	1% (0.5%)	0.01% (0.25%)
Suspension of Director's Illegal Action	1% (0.5%)	0.01% (0.25%)
Inspection of Accounting Books	3% (1.5%)	1% (0.5%)
Convening of the Shareholders General Meeting	3% (1.5%)	1% (0.5%)

*Figures in parentheses are applicable to large companies.

Table 4
Brokerage Commission

<u>Negotiable Rate System</u>			<u>Fixed Rate System</u>	
<u>Freely Negotiable</u>	<u>With Maximum</u>	<u>With Minimum</u>	<u>Sliding Scale</u>	<u>Single Rate</u>
Japan	Indonesia	Hong Kong	Malaysia*	China (0.35%)
Korea	(Max. 1%)	(Min. 0.25%)		
Thailand	Philippines		Taipei, China**	
	(Max. 1.5%)			

*Malaysia:
1% for trades up to M\$500,000
0.75% for M\$500,000 to M\$2 million
0.5% for M\$2 million

**Taipei, China
0.1425% for trades < NT\$10 million
0.1325% for NT\$10 million < trades < NT\$50 million
0.12% for NT\$50 million < trades < NT\$100 million
0.11% for NT\$100 million < trades < NT\$150 million
0.10% for trades over NT\$150 million