EMERGING MARKETS INVESTOR

Monitoring the markets

Market practice in Asia varies widely, affecting the safety and quality of investments. **Derek Duggan** of Thomas Murray report on the implications for both investor and custodian

Demand for information on local securities market infrastructure has grown dramatically in the past few years. Meanwhile the task of monitoring the relevant characteristics of markets is becoming increasingly complicated, as the number of markets open to direct investment continues to grow. This is especially true of Asia where once dormant or closed markets are now being actively considered by global investors.

As more markets in Asia open, and as the complexity of their investment instruments continues to grow, so do the challenges and issues faced by investors. Increasingly, it has become critical for these groups, and their agents who are responsible for the safety and administration of invested assets, to carefully review and formally evaluate the local market practices for the safekeeping, clearing and settlement of securities in every market where they invest.

Investors in Asia face markets with considerably divergent local securities market rules, regulations and practices, coupled with a lack of factual data presented in a consistent and precise format across each of these markets.

The Group of Thirty's (G30) compliance guidelines remain the most useful starting point when looking at the development of the local securities markets. Published in 1989, The G30 report on clearance and settlement systems in the world's securities markets highlighted the diversity and uneven quality of local settlement systems. The nine G30 recommendations were designed to standardise and improve the quality and practices of national clearance and settlement systems.

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Although significant progress has been made towards harmonising and automating settlement practices across Asia, the picture is not consistent across all countries, as figure 1 illustrates. On a regional basis Asia complies on average with between only four and five recommendations for equities. The compliance rate for fixed income (four recommendations) and money markets (between two and three recommendations) are even lower than equities.

Taking these individual country compliance tables, Thomas Murray has applied an overall G30 tier ranking to each country for each instrument type: ie, equities, fixed income and money market instruments. Figure 2 provides an indication of the overall G30 compliance statistics. Countries have been ranked as follows: Tier 1 – countries that comply with seven to nine recommendations, Tier 2 – four to six recommendations, Tier 3 – one to three recommendations; Tier 4 – zero recommendations; and N/A – where no market exists or data is unavailable.

While the recognised developed markets of Hong Kong and Korea provide no surprises, it is interesting to note the improving custody and settlement infrastructures of Malaysia, Pakistan, Singapore, Sri Lanka, Taiwan and Thailand. However, Bangladesh, India, the Philippines and Vietnam are clearly less advanced.

The harmonisation and automation of local clearing and settlement practices in Asia following G30 has helped to reduce the costs and risks of global investment, but only to a limited degree. As evidenced by the varying levels of G30 compliance, major country-by-country differences remain.

Investors now need to look beyond G30 and assess each market's individual settlement and custody systems from an operational and functional viewpoint and consider in more detail the implications of the local market infrastructure. A closer examination of any market beyond

Figure 1 Progress towards G30 recommendations – equities

	Trade comparison direct participants	Trade comparison indirect participants	Central depositories	Trade netting system	Delivery vs payment	Same-day funds	Rolling settlement on T+3	Securities lending/ borrowing	ISIN numbering
Bangladesh	Yes	No	No	No	Yes	No	Yes	No	No
China, Shanghai	Yes	No	Yes	No	Yes	Yes	Yes	No	Yes
China, Shenzhen	Yes	Yes	No	No	Yes	Yes	Yes	No	Yes
Hong Kong	Yes	Yes	Yes	No	Yes	Yes	Yes (T+2)	Yes	Yes
India	No	No	No	No	No	No	No	No	No
Indonesia	Yes	Yes	No	Yes	Yes	Yes (partial)	No	No	No
Korea	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	No
Malaysia	Yes	No	Yes	Yes	No	Yes	No	No	No
Pakistan	Yes	No	No	Yes	Yes	Yes	Yes	No	No
Philippines	No	No	No	No	No	Yes	No	No	No
Singapore	No	Yes	Yes	No	Yes	Yes	No	Yes	Yes
Sri Lanka	Yes	No	Yes	No	Yes	Yes	No	No	Yes
Taiwan	Yes	No	Yes	Yes	Yes	No	Yes (T–1)	No	No
Thailand	Yes	No	Yes	Yes	Yes	No	Yes	No	Yes
Vietnam	No	No	No	No	No	No	No	No	No

Source: Thomas Murray

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Figure 2 G30 compliance rankings

	Equities	Fixed income	Money market
Bangladesh	3	3	N/A
China, Shanghai	2	2	N/A
China, Shenzhen	2	N/A	N/A
Hong Kong	1	2	2
India	4	4	N/A
Indonesia	2	2	N/A
Korea	1	1	N/A
Malaysia	2	2	2
Pakistan	2	N/A	N/A
Philippines	3	3	3
Singapore	2	2	2
Sri Lanka	2	3	3
Taiwan	2	2	2
Thailand	2	3	3
Vietnam	4	4	4

Key:
Tier 1: seven to nine recommendations
Tier 2: four to six recommendations
Tier 3: one to three recommendations
Tier 4: no recommendations
N/A: no market/ data unavailable

Source: Thomas Murray

conventional asset management (investment mix) considerations should include an analysis of: the financial instrument mix available in each market; the legal repercussions of investing in a particular market; the presence of a central securities depository (CSD) in each market, the use of which may or may not be compulsory; and a closer examination of the specific market standards and practices for settlement, registration, proxy voting and taxation treaties.

The first and most fundamental feature of market differences is that the list of specific investments available to investors varies by market, and within markets by stock exchange, as does the format in which these are held: ie, bearer or registered (figure 3).

Even before a review of the investment alternatives, foreign investors are still subject to, and must be aware of, the market entry requirements (ie, approval/documentation requirements) which exist in six Asian countries: Bangladesh, China (Shanghai and Shenzhen), India, Korea, Sri Lanka and Taiwan. In addition, most markets have established some foreign investment restrictions which control repatriation of funds, investment in specific industries and sections, and declaration of holdings obligations.

Beyond G30, one factor affecting investors is the difference in legal and regulatory operating practices governing local securities services markets, as not all investors are given the same level of protection by the law in all countries. Figure 4 provides a summary of the legal safety, protection and administration of custody portfolio securities in Asia.

These are the four areas which the boards of directors of US mutual funds are required to consider when entering into foreign custody arrangements under rule 17f-5, and which other institutional investors – both in the US and overseas – should look to as key indicators of the appropriateness of holding securities in foreign markets from a legal perspective:

■ Access to books and records of a custodian: This looks at whether the laws of the local jurisdiction would restrict access by an investor's independent public accountant to the books and records of the custodian relating to the investor's assets – both cash and securities. The market norm is that in all the Asian markets covered, investors must provide for the right of access in a custodian agreement. In 44% of markets bank secrecy concerns apply, while in 33% of markets a right of access may exist in certain conditions.

■ Recovery of assets in the event of the bankruptcy of a custodian: This looks at the ability of an investor to recover its assets in the event of the bankruptcy or liquidation of the custodian.

■ Recovery of assets in the event of their loss by a custodian: This looks at the ability of an investor to recover assets that are lost by a custodian. Overall, the custodian may be liable in contract, tort, equity or under statute in 89% of Asian countries. In addition, procedures exist for replacing lost securities in 89% of markets, while no restrictions were reported in 11% of markets.

■ Foreign exchange controls: This looks at whether exchange controls exist that would limit or restrict the repatriation of earnings (as well as principal) relating to any investment. The findings show that foreign exchange controls exist in 67% of Asian markets (33% have no significant foreign exchange controls). In 11% of markets certain reporting requirements apply and only approved dealers can be used in 11% of markets.

Investors who maintain a watching brief on future changes to these legal questions should be reasonably well placed to develop a quasi-regulatory control framework against which to monitor the safety of their assets in individual jurisdictions.

The creation of CSDs was one of the main recommendations of G30. If implemented, it was felt that they would play a significant role in reducing inefficiencies of

Figure 3 Instruments and settlement dates

	EQUITIES			FIXED INCOME			MONEY MARKET		
	Registered	Bearer	Settlement date	Registered	Bearer	Settlement date	Registered	Bearer	Settlement date
Bangladesh	Yes	No	T+4	Yes	No	T+4	N/A	N/A	N/A
China, Shanghai	Yes	No	T+3	N/A	N/A	N/A	N/A	N/A	N/A
China, Shenzhen	Yes	No	T+3	N/A	N/A	N/A	N/A	N/A	N/A
Hong Kong	Yes	No	T+2	No	Yes	T+2	No	Yes	T+2
India	Yes	No	Variable	Yes	Yes	Variable	N/A	N/A	N/A
Indonesia	Yes	No	T+4	Yes	Yes	T+4/T+3	No	Yes	T+3
Korea	Yes	Yes	T+2	Yes	Yes	T+2	No	No	N/A
Malaysia	Yes	Yes, phy. shares	T+4/7	Yes	No	T+1	No	Yes	TD
Pakistan	Yes	Yes	T+7-T+13	Yes	Yes	T+7-T+13	N/A	N/A	N/A
Philippines	Yes	No	T+4	Yes	Yes	T+2	Yes	Yes	T+1
Singapore	Yes	No	T+5	Yes	Yes	T+5	No	Yes	T+2
Sri Lanka	Yes	No	T+7	Yes	No	T+7	No	No	T+1
Taiwan	Yes	No	T+1	No	Yes	TD	No	Yes	TD
Thailand	Yes	No	T+3	Yes	No	T+2	Yes	No	N/A
Vietnam	N/A	N/A	N/A	N/A	N/A	T+2	N/A	N/A	N/A

Source: Thomas Murray

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physical settlement and improving delivery versus payment (DVP) in local markets. 78% of the Asian markets have fully operational equity depositories (with 61% having a depository for fixed securities income and 28% for money markets instruments). Of the four markets without CSDs, India and the Philippines plan to have operational depositories before the end of 1996, while Bangladesh and Vietnam are reviewing development plans.

Despite the undoubted progress in Asia, global investors should be aware that there is no such entity as a typical or model CSD. There are wide differences in the functionality of, or services offered by, depositories: in their ownership and membership profiles; in the guarantees provided to users; and in the conflict between compulsory and optional usage. These differing characteristics create some very real issues and concerns, which global investors should consider as part of their analysis of the risk of global investment.

Finally, investors, asset managers and custodians must maintain a watching brief on evolving settlement cycles, registration timetables, proxy voting capabilities and taxation rates and double taxation treaties.

In Asia the average settlement cycle for securities is between T+3 and T+4 for both equities and fixed income instruments. Money market instruments usually settle between T-1 and T-2, but as figure 3 illustrates this varies both by market and by instrument type.

Registration remains another area of inconsistency. Registration is only automatic/same day in 21% of the Asian markets, while 16% take over eight weeks. The average registration time of equities is between two and eight weeks. The percentages take on a similar split for bonds. In terms of how registration is conducted, registration in the name of the beneficial owner is overwhelmingly the most popular means by which investors register their securities (88% equities, 72% bonds). Nominee names and street names are allowed in 55% of equity markets and 44% of bond markets.

Proxy voting is a well developed concept in the Asian markets. Foreign investors can vote by proxy in all of the Asia Pacific markets except the fledgling Vietnamese market. The average typical instruction deadline for receipt of completed proxy is four/five days before the meeting, but increases to 10 days on average in the Philippines.

78% of Asian markets have established taxation treaties with other countries, with an average number of 26 treaties each. Japan (47), Australia (36), India (38), Malaysia (28), Singapore (31) and Korea (27) have established the most taxation treaty links. Taiwan has only two treaties leaving most foreign investors exposed to the full rate of market taxes.

The task of those responsible for the administration of institutional assets across Asia has become immensely complex and at the same time immeasurably more important. Custody in Asia has developed into an important issue as it becomes clear that investment in these local markets, without good safekeeping and settlement, could generate significant administrative problems and in some cases financial losses.

Alongside moves towards G30 compliance, much progress has been made in developing the infrastructure of the Asian securities markets. However, as this article has demonstrated, a great deal of work remains to be carried out before investors can feel comfortable about the safety of their assets held at a local level and the costs and risks of investing in emerging markets. ■

The data in this article is taken from Thomas Murray's Worldwide Securities Market Report 1997

Figure 4 Legal summary of the safety, protection and administration of securities in local markets

Access to books and records of a custodian	
Access must be provided for in a custodian agreement	100%
Bank secrecy concerns apply	44%
A right of access may exist in certain circumstances	33%
Recovery of assets in the event of the bankruptcy of a custodian	
Cash is recoverable if certain conditions are met	83%
Securities are recoverable if certain conditions are met	94%
Securities aregenerally recoverable	17%
Claim to cash only as a general creditor	6%
Recovery of assets in the event of their loss by a custodian	
Custodian may be liable in contract, tort, equity or under statute	89%
Procedure exists for replacing lost securities	89%
No restrictions reported	11%
Foreign exchange controls	
No significant foreign exchange controls reported	33%
Certain reporting requirements apply	11%
Foreign exchange controls reported	67%
Only approved dealers can be used	11%

Source: Baker & McKenzie for the *Thomas Murray Worldwide Securities Market Report 1997*

Figure 5 Central securities deposits

	% of markets with an operational CSD	% of CSDs which are compulsory to use	% of CSDs which are guaranteed
Equities			
Yes	78%	79%	86%
No	22%	21%	14%
Fixed Income			
Yes	61%	45%	73%
No	39%	55%	27%
Money Markets			
Yes	28%	20%	60%
No	72%	80%	40%

Source: Thomas Murray

Figure 6 Proxy voting / registration timetable / number of taxation treaties – equities

	Typical instruction deadline for proxy voting	Registration time (average estimate)	Number of taxation treaties
Bangladesh	Meeting - 5	6 - 10 weeks	13
China, Shanghai	-	T+3	No
China, Shenzhen	-	T+3	No
Hong Kong	Meeting - 2	10 days	No
India	Meeting - 7	2 - 3 months	38
Indonesia	Meeting - 2	2 weeks	24
Korea	Meeting - 7	On SD	27
Malaysia	Meeting - 4	4 - 6 weeks	38
Pakistan	Meeting - 7	45 days	6
Philippines	Meeting - 10	4 - 6 weeks	22
Singapore	Meeting - 2	–	31
Sri Lanka	Meeting - 3	TD	24
Taiwan	Meeting - 3	1 day	2
Thailand	Meeting - 3	N/A	26
Vietnam	N/A	N/A	N/A

Source: Thomas Murray