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The recent fiasco involving three local stocks wiped billions off investors' portfolios. More seriously, it exposed major structural problems in Singapore's stock trading processes, which should be addressed to prevent the episode from repeating itself.

EYE ON THE ECONOMY

How to prevent another penny stock fiasco

By JONATHAN KWOK

AT THE start of this year, three locally listed companies – Blumont Group, Asiasons Capital and LionGold Corp – were worth a combined $2.34 billion.

By Tuesday, Oct 1, the trio's combined value had skyrocketed to $10.53 billion on the back of corporate acquisitions and a surge in interest in penny stocks, among other things.

But on Friday that week, the trio's ascent abruptly reversed. The shares took a massive dive, losing about $5 billion in market value in their first hour of trading before the Singapore Exchange (SGX) stepped in with a rare directive to suspend trading.

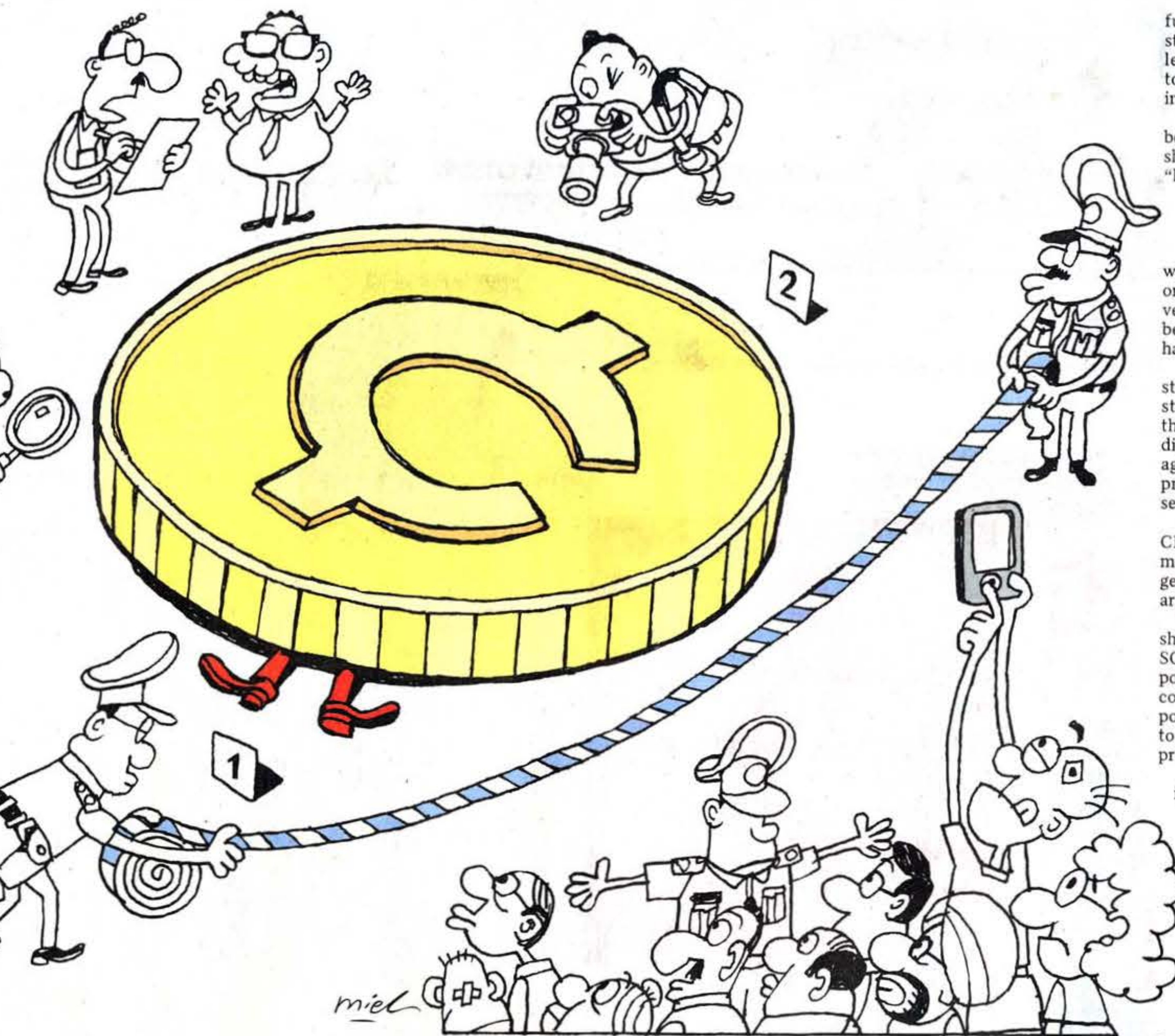
Trading soon resumed, though for a period the SGX slapped trading restrictions on the three counters.

They experienced a temporary fillip when the SGX lifted the restrictions but quickly reversed course on news that the Monetary Authority of Singapore (MAS) and the SGX were reviewing their trading activities. Last Friday, the combined market value of the three companies was only $842 million.

With restrictions now lifted and the financial damage done, the soul-searching has begun, not least because of the possible reputational damage to the bourse.

The MAS last week admitted that the episode "surfaced broader issues regarding the market structure and practices", which it will review with the SGX.

Some have questioned if the SGX could have acted earlier and more effectively when the three stocks were rising rapidly – and, market watchers say, beyond reasonable valuations.



The exchange issues public queries when a firm's shares move dramatically – as it did with the beleaguered trio – and it says these are signals to investors.

But such queries are often ignored. The next tools on hand are the SGX's tough measures of suspension and trading curbs, which kicked in only as the shares were collapsing. Before this, the last time such curbs were imposed was in 2008.

Calls have also been renewed for "circuit breakers", which will automatically halt trade if a stock's price fluctuates violently.

There were complaints about the confusion over how the curbs should be interpreted and the fact that investors had to wait four days to sell the shares even after paying cash for them upfront.

There were questions on whether insider trades in one of the stocks were disclosed in time.

Contra system

BUT one of the most fundamental issues that needs to be looked at is the archaic "contra" system for stock trading, which exists only in Singapore and Malaysia.

Investors here have up to three days to pay for their shares after buying them. During this time traders can decide to resell the shares they have just bought, and pocket or pay up just the difference rather than the full amount of their purchases.

Such practices have been around since 1930, when the predecessor of the Singapore and Malaysian bourses was established. Brokers in those early days were comfortable extending credit to clients. The investing community was small, and they knew their clients well. Eventually the system became institutionalised.

In the latest saga, contra trading allowed punters to push the three penny stocks to astronomical levels without any cash upfront, prompting criticisms that the system encourages short-term punts, and has no place in a developed financial system.

"Contra does not encourage investing; it encourages gambling," said Mr David Gerald, president and chief executive of the Securities Investors Association (Singapore), the main retail investor lobby group. "It encourages people to have a short-term view."

But contra trading has its defenders. They claim that Singapore's market is too small and must allow for contra to provide liquidity. Forcing full, upfront payments would likely reduce the volume of trades. Many traders still like to do short-term punts without putting cash upfront.

"To blame the woes solely on contra trading defies logic," said the Securities Association of Singapore (SAS), which represents brokerages serving retail investors. It noted that there are other forms of trading that rely on borrowed funds.

Mr Jimmy Ho, president of the Society of Remisiers (Singapore), argued in The Straits Times Forum that contra plays provide liquidity that is key during quiet periods when foreign funds are absent: "It is dangerous to take international practices (for example, disallowing contra plays) as the standard for determining the correct structure of our exchange."

Nonetheless, a strong case can be made for the use of contra to at least be reduced. The alternative of "cash trading" – where investors must pay upfront when they buy stocks – would limit the risk exposure of brokerage firms and their remisiers, who take on the credit risk during contra trading.

Despite cash trading being the norm in most markets, few brokers here offer it; Standard Chartered, Citibank and DBS Vickers are notable exceptions. The majority offer only contra trading.

Broking firms should offer both options. It will be win-win for all parties: cash trading involves lower commissions due to lower risks, so long-term investors can save on their costs. And the brokers will reduce their risks.

CPF Investment Scheme

THE second key area that needs review involves the Central Provident Fund Investment Scheme, which allows Singaporeans to invest their CPF monies – meant for retirement – in financial instruments, including shares.

Asiasons and Blumont are approved CPF investments, so some investors may have lost a part of their nest eggs recently.

In response to Business Times commentaries on this issue, the CPF Board said that no amount of tighter qualifying criteria can guarantee individual stocks will not run afoul of regulatory, accounting or governance standards.

It advised members to invest in funds, rather than individual stocks, to lower their risks – or to leave their cash savings untouched to earn CPF's guaranteed interest if they are risk-averse.

The CPF Board said some members will wish to invest directly in shares, so it is allowing this with "limits and safeguards". Its website says people can use up to only 35 per cent of their CPF investible savings for shares.

That is likely to cut little ice with Singaporeans who – rightly or wrongly – may assume that investments approved by CPF have been screened by the board and have a degree of legitimacy.

"When CPF (Board) puts a stock on the list, the man in the street may have the perception that somebody has done the due diligence," said Singapore Management University's associate professor Jeremy Goh, who researches corporate governance.

It would be draconian for the CPF Board to disallow investments in individual shares altogether. But the current criteria are arguably too lax.

To be on the scheme, the shares need only be listed on the SGX mainboard, traded in Singapore dollars as well as belong to a company incorporated in Singapore and allowing CPF investors to attend meetings. There are no profitability or size requirements.

One option is to restrict the investable stocks to larger companies, such as the blue-chips in the Straits Times Index.

Professor Goh suggested the CPF Board consider using some kind of corporate governance measure as a screening tool: "You cannot stop fraud, but to mitigate the risk they may want to consider measures, like the quality of the board."

Ultimate responsibility

WHILE systems need to be improved, it is important to note that ultimately investment decisions – and risks – fall on investors. This is only fair, as they pocket the upside if the stocks make gains.

The mantra of the market is "caveat emptor" – or "buyer beware" – and the onus is on individuals to manage their own risks.

But many investors here listen to third-party views rather than do their homework and make their own informed decisions, said Mr Gerald. "We have more speculators than investors."

With each stock market disaster, one hopes that Singapore investors are learning lessons – albeit painful ones – about doing their homework before investing.

jonkwok@sph.com.sg

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