



The stock market for all

2001:3

-new demands in a new environment



Summary and suggested measures

Dramatic price trend

The trend of the stock market during the past two years can justifiably be characterized as dramatic. A year of strong upward performance was followed by a year of sharp downturn. Substantial profits and substantial losses resulted for investors, making some into winners and causing others to suffer heavy losses. For others still, the profits of the upswing phase were more or less offset by the subsequent downturn.

Parallel with the dramatic development on the stock market, the structural transformation of the market continued unabated. This transformation involves an increasing internationalization, ongoing intensive technological development and rapidly expanding share ownership. The stock market has had the unusual tendency of globalization combined with the increasingly active participation of the man on the street. Household portfolios are currently dominated by different types of equity-related investments. It also appears that for certain types of people the equity market has acquired the character of a gaming and entertainment industry, which is reflected in its treatment by the media.

During the past two years, world equity markets have been markedly influenced by psychological mechanisms. In addition to the generally robust economic growth, the bear market was influenced by the debate about “the new economy”: the belief in future productivity development and profits was based on increasingly inflated share values. This belief was then shaken when the anticipated profits did not materialize, and the upswing was replaced by a powerful downturn. This sequence of events was a highly international phenomenon, but seems to have been more noticeable in Sweden than in many other countries, due in part to the intensive activity of the Swedish IT industry in recent years.

Has the market stood the test?

It is impossible for equity investors to completely protect themselves against the type of general share price fall that manifested itself over the past two years. Nor do such phenomena necessarily mean that the market is functioning “poorly” in any respect. Normally, the fluctuations of equity prices should be viewed as a normal tendency sending important signals to the economy, which in turn affects investments and the use of resources in the real economy. Normally, they do not merit the attention of the regulatory bodies, let alone require their intervention. It must be stated, however, that recent price movements have been extreme, and hardly representative of a perfectly functioning market. The dramatic price fluctuations in the equity market can also be viewed as a type of “stress test” that illustrated several weaknesses and problems in the market’s functioning – weakness and problems that in turn impact investment patterns and the allocation of real resources, as well as investors’ confidence in the equity market. Despite

these problems, it should be noted that the drastic changes in value were absorbed by the financial markets, in the sense that they have not affected financial stability so far.

Accordingly, there is reason to examine and follow up the observations made and the problems that appeared during the rise and fall that took place in the past 1–2 years. No doubt there are important lessons to be learned. This applies to investors and other players as well as to financial regulators.

In other words, it is not merely a matter of private finances and business economics. The recent development also raises issues about the functioning of the economy and the financial markets, about the behavior of the financial companies and how this interacts with existing regulations. In light of the protection issues affecting the financial sector, and which the Finansinspektionen (Swedish Financial Supervisory Authority, FI) must safeguard – stability, efficiency and good consumer protection – it is natural for the FI to undertake a systematic analysis of the development that has taken place. The fundamental issue for the FI is if and how the recent developments have revealed deficiencies in the market's functional capacity and in the norms and regulations governing the equity market. Here, issues of the functioning of information dissemination and share valuation appear to be the common denominator, and the focus of attention.

Equity exchanges and other marketplaces are part of the financial infrastructure and play a key role in the overall economy, ensuring that share trading may take place in an orderly manner and with low transaction costs. Markets and marketplaces create an information-processing system that creates the basis for the true valuation of individual companies. Therefore, the equity market plays a key role in the economy's allocation of resources.

However, the role of the equity market regarding the provision and processing of information is neither free nor perfect. Information is distributed unevenly among market players. The information content of share prices is affected by the strategic play between parties possessing different information about the underlying values of the market. Whether the equity market can be considered to function well or not thus depends largely on how information is disseminated between different players in the equity market.

Measures needed

The analysis conducted by the FI identifies several deficiencies in this respect and measures that could be discussed. Here too, the problems and deficiencies that may be observed are in many cases not unique for Sweden and the Swedish equity market. In times of rapidly increased international integration of both markets and market regulation, this should obviously be kept in mind. Nevertheless it is both important and natural for the FI to base its position on past events here in Sweden and discuss measures that could be implemented here.

The following are some key conclusions and suggested measures:

- Capital management and fund administration have the key task of exercising control over equity investments on behalf of their customers.

One approach is to develop a carefully thought-out ownership strategy, which should be communicated to the customers of such companies to enable them to select the appropriate level of investment risk and feel secure about their investment.

- The self-regulatory role of the Stockholm Exchange and other marketplaces must be examined in detail by the FI. The content of this role should be evaluated on a regular basis and its effectiveness should be considered in relation to the demands of the relevant legislation as well as to international harmonization in the regulatory area. Toward this end, the FI has charged the Exchange to report on its own experience of self-regulation.
- It is essential that all market-listed companies provide current, relevant information, and that this information is made available for all investors. A company website would be the natural vehicle for this. The three marketplaces should jointly devise minimum requirements for the content of such websites. The information should be standardized to some degree, to make it easier for investors to compare companies.
- Regarding prospectuses, a quality improvement is necessary, particularly considering that individual investors are increasingly using equities as their primary savings vehicle. This should primarily be the responsibility of issuing companies and their advisors (auditors and securities dealers). Self-regulation may play a key role in this context. Prospectuses should be subject to the same requirements as the listing of companies on authorized marketplaces and public exchanges.
- **Corporate finance** operations apparently have problems in handling conflicts of interest. The FI has taken measures to counteract these problems. The guidelines established by **The Swedish Securities Dealers Association** *Fondhandlareföreningen* help to strengthen corporate finance culture. However, there is reason to develop and sharpen current regulations and norms. The FI maintains an active dialog with market players.
- During the fiscal year, **auditors** should continually note and report on events. We should therefore welcome coming rules regarding audited interim reports and promote their prompt implementation.
- The trend toward accounting based on “fair value” should be supported. This should help to reduce the gap between traditional accounting and analysts’ company valuations.
- Investigations of improper insider trading and improper price influencing require considerable resources from the FI. The FI will develop tools to quickly deal with various incidents in the market. The Internet has become an important means of communication in the financial market and requires special monitoring.
- The responsibilities of an **advisor** should be set out in law. It must also be unambiguous for the consumer whether he or she is dealing with an independent advisor or with a sales representative of a certain company.

Concerning the limits placed on the concept of advisor, there is reason to define the concept of financial advice more closely. An important issue in the context, one which is a step ahead in the improvement and securing of basic competence among advisory personnel, is the **licensing** that is now to be implemented.

- Advice given should be followed up and subsequently evaluated. This presupposes a strengthening of the requirement for **documentation**. This is particularly important in connection with dispute resolution. To improve the situation for customers, the FI recently submitted a proposal for increased documentation requirements.