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The Domain of Securities Law

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This Conference has come at a time when the nation is taking stock of the development to date of its capital markets and is pondering the best system of securities law for the future. I am sure that the Organisers will be able to draw from the collective wisdom of the participants and thus perfect their own thinking.

We in Hong Kong have also been involved in a limited form of legal reform.

We have in April this year published for public consultation a proposed Composite Securities and Futures Bill consolidating eight pieces of legislation that the Hong Kong Securities and Futures Commission is charged with administering. Although this proposed Bill is essentially a piece of consolidation legislation, there are a few important innovations including powers much needed to regulate electronic trading facilities, unified licensing provisions applicable to all types of financial services regulated by the Commission, and most important of all, a modular form of construction of our legislation so that innovations of the future can be added as new modules. This piece of legislation will provide practitioners and the general public with a "one stop" reference point for the core of our securities law and will be a good platform for future legal reform.

We have also therefore been doing some of our own thinking on what securities law is about. I have therefore chosen, perhaps rather ostentatiously, to entitle my address, "The Domain of Securities

Law" not because I believe I can definitively define the boundaries of a living subject, that in fact is impossible, but because I hope that in so doing I can provoke thought both on my own part, and hopefully, also on the part of those attending this Conference.

Securities law, like all laws, seeks to bring order to behaviour. The behaviour which securities law seeks to order arises from markets and those who use them. It is therefore important that we first look at what markets do and attempt to state the conditions under which our markets are most likely to grow in the years to come.

Vast Potential

There cannot be any doubt that the securities markets of our nation will grow in the years to come to many times their present size. By World Bank statistics published in 1995, the country's stock market capitalisation in 1994 was 9% of GDP and total debt market value was 7% of GDP, whereas compared to the UK, the figures are 116% and 35% respectively and compared to the United States, the figures are 75% and 110% respectively. Undoubtedly there is much room for growth.

Drawing further from World Bank estimates, the need for capital to build infrastructure alone will be US$774 billion from 1995-2004, and China's demand for imports will be US$2 trillion from 1995-2004. So, undoubtedly there is much need for growth of our capital markets.

Our nation's 1995 Five Year Plan and the 2010 Strategic Vision has set a true course for the nation's development which recognises these infrastructure and import needs and the consequential need for development of the capital markets.

Eight Fundamental Features of Successful Markets

As I am not an economist, I will not try to enter into a formal discourse as to the workings of markets. But as a regulator, I would venture to suggest eight fundamental features of successful financial markets:

- *First*, financial products are in the final analysis bundles of information, so financial markets are markets of information. The more fairly, freely, and accurately is information disseminated, the more likely it is that a financial product is bought and sold at its true value. This fundamental feature of financial markets is often called its "transparency". All successful markets have a high degree of transparency.
- *Second*, financial transactions like all transactions must be executed with the greatest possible speed at the lowest possible cost. In other words, transactions must be executed efficiently. No market which is inefficient will last for long.
- *Third*, markets are where the exchange of product and funds take place. This exchange seldom takes place simultaneously with the sale. Buyers and sellers could be hundreds or thousands of kilometers apart. It also takes time for a seller to get ready his product and a buyer to get ready his funds for the exchange. No market can exist for long without guaranteeing the certainty of this exchange, namely, the certainty of settlement of the mutual obligations of a sale.
- *Fourth*, as financial products are traded in the markets, they fluctuate in price. The time lag between sale and settlement exposes market participants to the risk of price fluctuation. This risk is multiplied if financial products are bought and sold with borrowed funds or if the products themselves represent contractual rights and obligations dependent upon fluctuations in the markets. No market can exist for long if it did not have a good system for managing such risks.
- *Fifth*, financial products are usually bought and sold through intermediaries. Intermediaries therefore handle their clients' property, whether it be money or documents evidencing title to

a financial product. Intermediaries thus owe duties to clients, and since they also participate in the markets, they owe duties to other market participants. No market can exist for long if there is no confidence placed on such intermediaries. Thus every market has business conduct rules which on the one hand, seek to protect the clients of intermediaries, and on the other, seek to protect other market participants.

- *Sixth*, financial markets require a clear system of rules which are effectively and consistently enforced so that rights, obligations and duties exist not only on paper but also in fact. No market can exist for long without this important feature.
- *Seventh*, financial markets require skilled practitioners. These practitioners should include intermediaries skilled in buying and selling financial products but also intermediaries skilled in investment management. In addition, there must be skilled supporting professionals in law, accounting and commercial and investment banking. No market will advance without a skilled corp of market and supporting practitioners.
- *Eighth*, financial markets require informed investors who understand the risks and rewards of different types of financial investment as well as what their rights are as clients of intermediaries. This understanding in turn makes demands on intermediaries so that if they do not improve, business would go elsewhere. A market without a sufficiently large number of informed investors will never mature and will never truly grow.

The system of securities law of any jurisdiction should enable its financial markets to acquire the above fundamental features. In time I am certain that the system of securities laws of our nation will succeed in creating the right conditions for growth of our markets. Meanwhile, let me suggest that in building the systems of the future, we might first consider two sets of questions:

- What should be regarded as the proper domain of securities law?

- What are the considerations which should be taken into account in deciding the structure and substance of a specialised securities law?

The Domain of Securities Law

I would like to stress that we should look at securities law as a system rather than as a single law, since securities law must exist as part of a legal system. As to what constitutes the general domain of securities law, I would suggest that we might envision the system to consist of concentric rings:

- *First*, I would suggest that at the centre ring is the general law in our legal system which defines civil capacity, rights, obligations and duties. I would regard the domain of the civil law as constituting the foundations of our system of securities law.
- *Second*, at the second ring should be one or more (preferably one) law which deals specifically with the regulation of securities markets and their participants. This is what most countries call "securities law" but I put this at the second ring because at the centre of all things is the civil law.
- *Third*, further out from the centre are all other laws which affect rights, obligations and duties in relation to securities products. For the purpose of illustration, the Joint-stock Company Law, laws and regulations relating to accounting standards and valuation of property, bankruptcy law, and laws and regulations relating to banking particularly in relation to the provision of credit and negotiable instruments.

Practitioners and legislators should not forget that no specialised securities law stands alone. Therefore, they should not forget to take account of developments in the civil law and other law relating to financial products. But since we have only limited time, let me now

explore the second ring and also the second set of questions: the structure and substance of a specialised securities law.

The Definition of Securities

The obvious first question to ask in relation to a securities law is what constitutes the concept of "securities". Many jurisdictions, including Hong Kong, have not found the task an easy one because it is sometimes possible to construct a derivative financial product which falls outside the legal definition and thereby evade regulation. The tendency around the world has therefore been to give the widest possible definition to the term "securities" so that as many derivative instruments as possible might be caught. However, problems will probably arise if either there are separate exchanges trading securities and futures or if there are separate public agencies regulating futures and securities. In the first case, we have witnessed heated litigation between the Australian Stock Exchange and the Sydney Futures Exchange. In the second, the SEC and CFTC of the United States, despite the Shad-Johnson Accord, continue to struggle to define the boundaries of regulatory oversight between the two agencies.

This definitional issue has led to a number of organisational and legal solutions.

Organisationally, many jurisdictions have opted for a single regulatory agency overseeing both securities and futures markets and their participants. This model has been adopted in the UK, Europe and nearly all Asian countries which have capital markets.

Legally, the definitional solutions have not been as uniform. Whilst every jurisdiction tends to use wide definitions for the term "securities" and "futures", there have been few which have made specific provision to deal with derivative products which fall into or out of both definitions. This has led the Thai Securities and Exchange Act to reserve to the Thai SEC the power to designate any financial product a "security". That is a neat legal solution but one which some

jurisdictions may find difficult to enact into law since it might be perceived as giving too much power to a regulatory agency. In the United Kingdom, the solution is not to use the term "securities" and "futures" at all but the wider concept of "investment" which is defined by a long statutory list which could be added to or subtracted from by Ministerial Order. In Hong Kong, our Composite Securities and Futures Bill propose that our exchanges may in addition to their core products trade any product approved by the Securities and Futures Commission.

Banking vs. Securities Regulation

The next issue which commonly arises is the division between banking and securities regulation. That has not been a problem for over 60 years in the United States in view of the prohibition introduced by the Glass-Steagall Act against securities dealings by banks. Thus banking regulation and securities regulation has proceeded side by side save when the payment system is involved in settling securities transactions or when the banking system is involved in credit extended to securities transactions.

In Europe, banks have traditionally been the principal intermediaries who conducted securities dealing either on behalf of themselves and/or on behalf of clients. Thus banking regulators have also included the regulation of these activities in their banking regulation work. As non-banking securities market intermediaries are established, many European countries (and many Asian and Latin American countries) have set up dedicated securities regulatory agencies. Not surprisingly, the first question which these countries have had to face was whether banking regulators should continue to regulate the securities activities of banks. Every country which had been faced with the question had answered the question one way: that the banking regulator will be the primary regulator of the bank for the regulation of its banking business and its financial soundness, but the bank's securities activities would be regulated by the securities

regulator. The reason for such unanimity is quite simply that effective regulation has to be focussed. Banking regulation focuses primarily on financial soundness of a bank whereas securities regulation primarily focuses on conduct in the market and conduct to clients. Furthermore, the securities industry is changing rapidly with advances in technology, and only a specialised regulator can be expected to keep up.

Eight Fundamental Decisions

Since effective regulation has to be focussed, so it is important that the functions of a securities regulatory agency should be clearly and fully defined. I would suggest that we might focus on eight fundamental decisions which will have to be made in constructing a securities law.

Decision 1: The ambit of activity oversight

The first decision that is needed is the ambit of activity oversight, i.e., whether it is securities alone or securities and futures or securities and such other types of investment as may be specified by the State Council. The first exposes the securities law to the definitional problems I have earlier alluded to. The second gives the agency a wider berth. The third is obviously the most flexible.

Decision 2: The ambit of institutional oversight

The second decision that is needed is the ambit of institutional oversight: i.e., what are the types of market organisations and participants it is intended to regulate. It is usual to include exchanges, clearing houses and the intermediaries involved in the activities over which the agency has regulatory oversight. It is also usual to exercise institutional oversight by way of licensing powers so that conditions could be placed on the licences and failure to observe such conditions would

result in appropriate sanctions, including fines, suspension and in the worst cases, revocation.

Decision 3: The ambit and substance of personal oversight

The third question to consider is the ambit and substance of personal oversight. The essential limitation of institutional oversight is that it is often socially impossible to revoke the licence of an institution which has many clients and employees. This is the same issue which faces nations which are able to exercise the nuclear deterrent: namely, no one wants to use a nuclear weapon. Thus institutions have a tendency to test the limits of regulation. This and the further reason that all institutions in the end work through individuals, really means that there should be some means to regulate the conduct of individuals working either as employees or agents of regulated institutions. This could be achieved by a system of licensing either directly by the regulatory agency or by a Self-Regulatory Organisation such as an Exchange, on behalf of the regulatory agency. Usually, licensing conditions require the observance of a "Code of Conduct" and maintenance of the qualifications of a conduct and educational nature which had made a licensee "fit and proper" to be licensed in the first place.

Decision 4: The ambit of regulated conduct

The fourth decision that is needed is the ambit of regulated conduct beyond the ambit of the institutional and individual licensing system or any system of self-regulation. In the former case, conduct is enforced because every licensee needs to maintain good standing. In the latter, conduct is enforced by agreement among the subscribers to the self-regulation system. Misconduct not caught by these two situations normally relate to the use of fraudulent devices in securities dealing, such as insider dealing and creation of false markets. It will be necessary to decide on the types of conduct which should be prohibited and

what consequences should be visited upon the perpetrators. Here many jurisdictions have legislated for both criminal and civil sanctions which the regulatory agency concerned may pursue in the courts. I do not think I need say more than stress that sanctions have to be sufficiently strong to be effective. Thus criminal sanctions in most countries tend to include heavy fines and imprisonment. Civil sanctions tend to include civil penalties of up to three times the profit made from illegal dealings.

Decision 5 : The ambit of powers

The fifth decision relates to the ambit of powers outside those prescribed for the licensing system. It must be acknowledged that a regulatory agency without power is like a tiger without teeth. Therefore, the following five types of powers are usually given to securities regulatory agencies:

(i) *Investigatory powers*: enabling the regulatory agency to investigate anyone suspected of failing to comply with any aspect of the securities law.

(ii) *Directory powers*: enabling the regulatory agency to direct a licensed person or institution to undertake business in a manner directed by the agency so as to protect investors or to protect the integrity of the financial markets.

(iii) *Prosecutorial powers*: enabling the regulatory agency to commence criminal and civil actions in the courts to punish or to recover compensation for or to prevent misconduct.

(iv) *Mutual assistance powers*: enabling the regulatory agency to investigate on behalf of an overseas agency persons or institutions involved in misconduct in the markets of an overseas agency, on a reciprocity basis.

(v) *Rule making powers*: enabling the regulatory agency to spell out in detail how certain provisions in the securities law may be complied with. Most jurisdictions have a negative vetting procedure for such rules, namely, that they are communicated

to the legislature or other organ of state which may within a specified time amend or repeal the rule.

Decision 6: The ambit of protection

The sixth decision which is needed is the ambit of protection to be afforded to the regulatory agency and its officers. Because financial markets are so sensitive to information, all kinds of pressures are liable to be exerted on a regulatory agency for information as to its investigatory activities. In addition, because so much is often at stake in the financial markets, regulatory agencies and their officers are liable to become targets of litigation. Therefore, it will be necessary to introduce in the law, a prohibition against disclosure of information relating to investigation unless strict conditions are met as well as immunity against legal action where the Commission and its officers have performed their duty in good faith.

Decision 7: Adjudicatory machinery

The seventh decision is to decide on the types of adjudicatory machinery needed to deal with misconduct prescribed in the securities law. It will be necessary to consider whether in addition to the courts, independent tribunals should be formed to deal with appeals from licensing decisions or whether arbitration can be used for civil actions.

Decision 8: Regulatory philosophy

The eighth decision is whether regulatory philosophy should be included in the securities law. Many jurisdictions do in fact do this by including in the functions of the regulatory body general statements of regulatory objectives. In our proposed Composite Securities and Futures Bill, we have proposed to include a number of general statements of regulatory philosophy to help us focus on our task at all times.

In making these eight decisions, I would add one caveat. It must be remembered that markets are in a constant state of flux. Thus legislation should be drafted with sufficient flexibility to reasonably accommodate market innovations and other changes of circumstances.

Conclusion

I hope that the above brief discussion of the eight features of successful markets and the eight decisions which might have to be taken will in some small way provide a degree of focus to the discussions of the distinguished participants of this Conference. There is of course no magic to the number of features and decisions that I have sought to set out. As you proceed you may either add or subtract to the numbers but I hope that the number 88, which is a very lucky number, at least for the financial markets, will provide an auspicious start to these proceedings.