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Challenges of a Rising Market

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I can't possibly cover all of the challenges that come from a rising market and in some ways, it's very strange that I should have to. You've all been following the media over recent weeks. You are all familiar with the details of the biggest stock market boom Hong Kong has ever known. The highlights are that Hong Kong is now the sixth largest market in the world. The index is at a record high. We have had months where stocks have been doubling, tripling and in some cases, quadrupling. But much more important from a regulator's point of view, the volume has hit record highs. Yesterday, turnover was $28 billion. Today, it looks like it might go to $30 billion. It was $15 billion when I left the office and the market was up 50 points on the previous record. It had been struggling to get there but it managed it.

So, what's a regulator doing talking about all of that? Well, in Roman days, when a General was awarded a triumph for winning a great victory, he got to ride in his chariot through cheering crowds. There was a slave whose duty was to stand in that chariot and whisper in his ear as he went, "Remember, you are mortal." That, unfortunately, is the regulator's task at times like this.

It's not our task to tell you how to invest your money or how risky it is or whether or not you should be speculating or whether speculation is healthy or unhealthy. But we do have to remind people of some of the risks that emerge. If you are unlucky enough to be in charge of the Enforcement Division, you get an even less popular job, which is dealing not just with the risk that things may go wrong but trying to identify, pursue and regrettably, punish the people who do go wrong. They are a small minority in the market but they are the majority of what Enforcement deals with.

Now, the reason that our job gets more interesting and more challenging at times like this is that the self-regulation system comes under a great degree of stress. One of the great strengths of the Hong Kong market is that by and large, it relies on self-regulation of the industry by the industry. That is the first line of defence. The next line of defence is the Stock Exchange, usually called the frontline regulator, but in fact it's the second line. Behind that is the SFC and at the very backline of the SFC, there's an enforcement function, which has about 40 professional staff with some supporting clerical staff and secretaries. The reason for pressure on all these parts of the system is not so much the rise in the index or in prices of some stocks but the rise in turnover and the rise in deal flow. The rise in turnover is associated with a big change in the nature and behaviour of the market.

Right now you have retail activity on a scale not seen for many years in Hong Kong. Some of the older brokers tell me that that reminds them of 1973 rather than 1986. And certainly our own market surveillance tends to confirm that. The market is moving from a position where it was dominated by institutional trading of blue chips to a market which is increasingly dominated by very active retail trading of a broad range of stocks in the market and moving away from the blue chips. And you will see retail investors, often with not a very high net worth, doing four or five pages of single transactions in three or four stocks a day, basically day trading extremely actively, sitting in the broker's office watching the screen, having a coffee, giving their orders. And that's where a lot of this $28 billion is coming from.

Because the market becomes concept-driven, directors of listed companies have to change the way they think about communicating with the marketplace. Information that wasn't price sensitive, such as remote plans, prospects, tentative approaches by people that might possibly lead to some business suddenly become price sensitive as does the presence of rumours about them in the market. The other great adjustment of course is that there are very few directors of listed companies who get as concerned about a rise in the share price as they do about a fall. It's very easy to take the good news as your due and not say to yourself maybe there is something wrong here, maybe people misunderstand the company, maybe I'd better check what's causing this, maybe I'd better talk to the Exchange.

Also, the corporate finance industry comes under incredible pressure. Because the market is very active, because no one knows how long the good times will last, because there's an amazing deal flow, they have less time. They are now under considerable client pressure to get transactions done, to get them through the system, to get the regulators happy. They also have less time to do due diligence. And the opportunity cost of due diligence rises. The more time they spend investigating one company making sure they're comfortable with the deal and with the numbers, the more deals they're missing out on what would come down the pipeline if they could free up the time.

Investor caution is relaxed. I have been watching the screen very closely for market surveillance reasons over the past few months and if I were an active investor, I could have expected an average return for a day of about a million dollars just from day trading the stocks that tended to move. So there has been a very quick move from the market being concept-driven by the China concept to being rumour-driven and then trading-driven. Actually, at the moment, it has been an effective strategy to buy the stocks that start moving at the start of the day and provided you watch the screen and get out quickly if it goes against you, you'll probably do very nicely. Some stocks are moving up 10%, 15%, 20%, or even 25% a day.

Now, that creates an ideal environment for that very small minority of people who will inside deal, who will manipulate the market. Insider dealing becomes very profitable. False rumours can become very productive because they move the price. And market manipulation becomes very easy to start because all you have to do is give the stock a starting momentum and the day traders will come in and do the rest for you. It also becomes much, much harder to detect.

In such a scenario, the Stock Exchange, and the SFC, especially the Corporate Finance Division, come under pressure. They have so many transactions to process, so many things to look at, so many announcements and circulars to vet, all of which have to be done in a very timely fashion. But maintaining the usual level of scrutiny is very difficult. On top of that, the corporate finance industry is not using as much care as it normally does. The net effect is that, to maintain standards of service, the frontline regulator ends up deferring disciplinary action and ends up deferring enquiry actions. That sends a signal to the unscrupulous people that they can get away with more - so that you can have a negative message in the marketplace.

So the problems come through to Enforcement. The problem with enforcement is that we are not very good at getting messages across quickly. We can't talk about our work in detail. We're subject to very strict secrecy provisions. Furthermore, enforcement is about deterring misconduct by catching people and punishing them and that takes a long time. For misconduct in 1997, the chances are any proceedings will take place in late 1998 whether they are proceedings before the magistrate or before the insider dealing tribunal or whatever.

It was to overcome these problems that the Stock Exchange and the SFC sat down to discuss what we could do to take a more pro-active approach to head off emerging misconduct and the most visible outcome of that discussion was the joint policy announcement issued by the Stock Exchange and the SFC on 21 May. That announcement is usually referred to these days as "the suspension policy". But in fact, it goes a lot further. People should read it very carefully. It says, among some revolutionary things, that the Stock Exchange and the SFC will hold people to the announcements they make. If you say that you're not going to engage in a transaction, you're not going to make a placement, you're not going to do a rights issue, you're not engaged in negotiations with a Mainland party, then the chances are very good that you will not get the requisite waivers and the requisite listing permissions for the new shares you need to complete any deal that does emerge, or at least you'll have to give a very good explanation as to why you said one thing and now you're doing another.

But it's the suspension aspect of that policy that I need to administer or help in administering. I've been advised that it's a bit misunderstood and that I should talk about it.

The other thing that very brief announcement said was that from now on the regulators would try to examine movements in the markets very closely. If we saw unusual, unexplained increases in price and volume, the stock would be suspended and would be suspended for as long as it took to work out what was going on. Since that policy was announced, we've suspended about three dozen stocks. Most of those stocks, by the way, stayed suspended for a fortnight or so, and people seem to think that's a long time. Other stocks have been suspended for some months and there are one or two that we are looking at that may be suspended almost indefinitely. That's where there's a particular problem identified in the surveillance process that means that the company has to announce something it does not want to announce or it has to complete a transaction before it can go forward.

The way we work out what to suspend is that we look at a range of criteria. They're all common-sense criteria. We look at the extent of the price movement and pay attention to volume. If you see the price is moving a lot with very low volume, we take no action. One day, we may come back and look at those stocks to see if they are liquid or if they have a proper free public float but we haven't got time to do that now. The other is the relationships to fundamentals. Quite a lot of stocks in Hong Kong have been very very under-valued and it's not unnatural that they should enjoy a re-rating as soon as they're analysed. So, if the P/E is going to the tens to twenties, it's not necessarily grounds for concern. We look at the velocity of the trading. We look at the nature and the source of the buying activity. We're getting pretty good at identifying broking firms who are certainly mixed up in these stocks quite a lot. We look at the historical performance of a stock and then we make a judgment call. Because it's a judgment call we don't always get it right. We're not perfectly consistent. We've examined some stocks we suspended, and found the cause of the move was just a change of market sentiment. We've failed to suspend others which, with the benefit of hindsight, we probably should have suspended. So, it will never be perfect. But the policy will continue.

As a result of that surveillance process, we have instituted, by our standards, a significant number of section 33 investigations. It does cover a significant proportion of the stocks suspended. That means that we're now investigating suspected insider dealing, market manipulation, breaches of the Takeovers Code and other serious offences in relation to those stocks. Stocks that are being investigated include some Mainland-related entities and some Hong Kong entities. The policy is applied uniformly to every sort of company. It will continue to be so applied.

It's far too early to say whether we will be able to establish that misconduct occurred or whether there's an innocent explanation in some cases.

But it's a deliberate object of these investigations that, where there has been suspected misconduct of a serious nature, to extend the scope of our investigation to those who facilitated the conduct, not just the insider dealers or market makers, but to those who stood by and let it occur when they should have taken action that could have prevented it.

At the moment the self-regulatory system needs a degree of reinforcement. Some people are not discharging the responsibilities that they have and we need to make some examples to get the lesson across that there's no competitive advantage from being negligent. So, we are interested in whether a company director should have released information more fully, more fairly and earlier. We remain interested in when a company director should have gone on an inquiry, or at least discussed with the Stock Exchange why there was an unexplained price movement.

In relation to intermediaries, they have a duty to act honestly and fairly, in the best interests of their clients and of the integrity of the market and to use due skill, care and diligence in doing so. Also to know their clients. Sometimes, that might mean they have to advise a retail investor against buying a share. That will be rare. Sometimes, it will mean they have to advise a party against certain transactions.

But it will always mean that they cannot associate themselves with what they suspect might be misconduct. They have a duty to go on enquiry. They have a duty to refuse to act.

I'm not talking here primarily about the broking industry. The message is very largely aimed at the financial advisory industry, the people who act as intermediaries between the listed companies and the Stock Exchange and the SFC. They need to make sure that when they make a representation to us, for whatever reason, it's one they believe on reasonable grounds is true. It's not enough to say that they believed the client. It's not enough to say that they made a mistake. They have a duty of due diligence and duty of good faith toward regulators. It's only a very small minority of the advisers who are taking an advocacy role rather than discharging their responsibility, to bring the interests of the clients and the interests of the market together in a constructive way. That's where the expertise comes in. That's what they get paid for.

This is a message about a very small minority. Because I'm an enforcer, it sounds like a threat. For most of the financial industry in Hong Kong, for most of the directors of listed companies, I hope it's not a threat. I hope it's a reminder that you must be vigilant. You must remember that we are not immortal. You must do what you can to reinforce the self-regulatory part of the system in the interest of the whole of the market and of the long-term development of Hong Kong. I am actually personally very confident that that will happen.

Hong Kong faced a major challenge after 1987. It rose to that challenge of establishing international credibility quickly and well. It now needs to respond to the new challenge of re-establishing credibility at the opening stages of what the world sees as a new market - Hong

Kong as a credible financial centre that holds to international standards. We're hoping to strengthen the self-regulatory system as much as possible. We need the flexibility and adaptability that self-regulation provides. I'm an enforcer but I do not want to see new rules, black letter rules, new laws giving new powers to us. What we want to see is self-regulation to be effective to the degree it traditionally has.