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# 23 Securities Market Reform: the Hong Kong Experience

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It is always a pleasure for me to be back in the San Francisco Bay Area. I lived here for 10 years and started my legal career here in the early 80s. I am therefore particularly honoured to be invited by the Commonwealth Club to address you today.

Stock and derivative exchanges around the world have witnessed rapid changes in the last few years. The proliferation of alternative trading systems and electronic communications networks (ECNs), particularly in the US, has substantially lowered transaction costs and directly facilitated on-line trading by investors. Traditional methods of stock and derivatives transactions are fast becoming outdated and costly. More and more investors are discovering the ease of trading from their desks without using intermediaries.

News of demutualization, mergers and alliances of exchanges take place almost on a monthly basis. In Hong Kong, both the stock and futures exchanges have demutualized and merged under a new holding company. This was accomplished within 12 months. This new holding company will soon become a listed company on its own exchange.

Hong Kong is far from being alone in such large-scale transformation. A survey conducted at the end of 1999 showed that 15 exchanges worldwide had already demutualized, 14 were about to do so, and another 15 were seriously contemplating it. Among those which have already demutualized are exchanges in Australia,

Amsterdam, Frankfurt, Stockholm, Singapore, and Toronto. Of these, the Australian, Amsterdam and Stockholm Stock Exchanges have also become listed companies themselves.

Exchanges are also racing to form mergers and alliances. This phenomenon is particularly prevalent in Europe. The derivatives exchanges in Germany and Switzerland have merged to become Eurex in 1997. Eurex has overtaken London's derivatives market in size in 1998 and that of the Chicago Board of Trades in 1999. The Paris, Brussels and Amsterdam Stock Exchanges joined together to form a regional exchange called Euronext in April this year. This was followed by the proposed merger of the London Stock Exchange and the Deutsche Borse in Frankfurt. In the US, both NASD and the New York Stock Exchange, as well as the Chicago Exchanges, have all announced plans to form strategic alliances with overseas exchanges.

These developments raise a number of important questions: What has been the driving force of such dramatic changes? The exchanges have existed largely in their current form and structure for the better part of the last two centuries. What caused them to transform themselves now? What will the securities market be like in the future? And how will investors be affected in the new financial landscape?

## The Forces of Change

There is no question that technology is the key agent for change. Technological innovation in recent years has improved trading efficiency and caused the explosion of ECNs. ECNs have brought an unprecedented number of first-time investors to the market by enabling investors to trade directly from their personal computers and in the comfort and privacy of their own homes. Reduced transaction costs of trading through this new method has encouraged investors to trade more actively and frequently. As a result, transaction volume, liquidity, and volatility in the market have all increased.

The Internet has given investors easy access to stock information, which further enhances their ability to conduct trades directly. The existing business model of traditional brokerages is under threat.

Put another way, ECNs and Internet have hastened the disintermediation process so feared by the industry. Consolidation of the industry is inevitable.

Frustrated by the outdated governance structure and the protected environments of traditional exchanges, firms like Goldman Sachs, Morgan Stanley and Merrill Lynch became key investors in some of the largest ECNs such as Archipelago, Optimark and Tradepoint. Their participation in ECNs has changed the alignment of interests in the marketplace. Financial institutions, market participants, and markets themselves are converging. The distinction between marketplace and market participants is fast disappearing.

Lastly, globalization of financial markets has blurred geographical borders which define traditional exchanges. Investors are increasingly investing in foreign markets while dual listings or dual trading by issuers on multiple markets are becoming common. Markets must cater for cross-border transactions in order to attract the bulk of such business. Mergers and alliances of regional exchanges are the inevitable results.

Exchanges must continue to upgrade themselves in order to be a competitive marketplace for their customers. They must also equip themselves to be an attractive candidate for possible merger or alliance with other partners. Failure to reform would put an exchange at the risk of losing its franchise and being marginalized in the global financial markets.

## The Need for Reform

The very first step of market structure reform for traditional exchanges is demutualization.

The distinguishing features of a mutually-owned exchange are that the owners of the enterprise, its decision-makers and the direct users of its trading services are the same entities: the member firms. Decisions are usually made on a one-member, one-vote basis. Value in membership is enhanced by limiting its supply. Members in general are unlikely to vote for any changes which would require them to put in additional capital, or threaten their customary way of doing business, or decrease the potential value of their membership. This form of exchange structure and governance tends to place members' interest above those of the market and the investors. It also inhibits the exchanges from responding quickly to changes brought by new technologies.

Demutualization liberates a traditional exchange from the constraints of such structure. In a traditional exchange, ownership rights and trading rights are one and the same and not easily transferable. Demutualization will segregate current members' ownership rights from their trading rights and create value in both of these rights. Members' ownership rights are transformed into shares, while their trading rights may be maintained. If the demutualized exchange becomes a listed company, its shares will also be freely tradable.

As a commercial organization, a demutualized exchange will have to be more customer-oriented and profit-driven. It will have to focus on the business aspects of operating a marketplace, and will be able to raise capital from the public. This will enable it to invest in technology and systems and compete with the ECNs. It can even acquire other companies in the industry.

However, demutualization also introduces new elements into the environment. The common concern is that the commercial pressures for profit will undermine the exchange's commitment of resources to carry out its regulatory responsibilities in the public interest. In order to generate and maintain its business, a demutualized exchange may lower its listing standards or be less vigorous in compliance and enforcement matters. The performance of regulatory functions in these

areas directly impacts on an exchange's profitability. This may result in lesser standards in the market in general.

**The Hong Kong Experience**

Like many other exchanges, the stock and futures exchanges of Hong Kong were membership organizations. Prior to demutualization last year, our Stock Exchange had nearly 700 members, of which less than 500 were active in trading. Of the 500, over 80% were small local brokers who contributed to less than 20% of the total volume on the exchange. This meant that 20% of the active membership, which were mostly large international institutions and other medium-size firms, contributed to 80% of the business on the exchange. However, they did not have a proportionate voice in the management and operation of the exchange because of the one-member-one-vote governance structure. In addition, competition between our stock and futures exchanges resulted in three different clearing houses for the two markets. This was a cumbersome and duplicative structure.

The Hong Kong Stock Exchange is the second largest stock market in Asia behind Tokyo, and the ninth largest in the world in terms of market capitalization and turnover. We are the most liquid and free market in Asia. Our currency is pegged to the US dollar, we are a common law jurisdiction and have a respected regulatory system. We have played a key role in bringing international capital to Chinese state-owned enterprises in the last decade, and will benefit from the further development of the economy as China enters the WTO. However, we would risk losing our current dominant position in the Region and unable to capitalize on our advantages if our market structure and mode of operation remained outdated.

Given these dynamics and developments around the world, the Securities and Futures Commission, together with the Hong Kong Government, decided that the Hong Kong market needed to quickly

reinvent itself in order to be a viable player in the global financial scene.

The Commission and the Government determined that market reform would be best achieved through demutualizing both Exchanges and merging them with the three clearing houses under a single holding company. The merger of these entities under one umbrella would bring economies of scale in operational efficiency and infrastructure investment. Common ownership of the cash and derivatives markets will centralize the Exchange's business focus, create critical mass for new product development, and direct the competitive attention of both exchanges to forces outside Hong Kong rather than to each other.

The merger aspect of the reform proposal in Hong Kong meant that in addition to obtaining value for their ownership rights in their respective Exchange, members would be able to share in the growth and profit of a business combining both the cash and derivatives markets.

To ensure that members would vote for demutualization, the Commission and the Government permitted a cash alternative from the Exchange's reserves for those members who wished to realize the value of their membership immediately instead of receiving shares of the new company. It was also agreed that the merged entity would not issue any new trading right for a period of two years. These measures ensure that the small brokers would have a two-year transition to equip themselves for the new market environment.

To address the concerns of conflicts of interests inherent in a demutualized exchange described earlier, the enabling legislation of the merger provided that eight of the 15 board members of the new holding company would be independent members appointed by the Government. This would ensure that the public interest of the market would be safeguarded. The independent Board members will also balance the Exchange's drive for profit with the need for adequate regulation of the market. It is envisaged that with the public listing of the holding company and enlarged public ownership of the exchanges, the number of Government appointees will be reduced over time.

We recognize that demutualization is only the first step in the reform of market structure. It is not a panacea for what is needed to make a market modern and competitive. To keep up with the latest technology, both our Stock and Futures Exchanges will introduce a new generation of Automatic Order Matching and Trade Execution system later this year. The new system will provide interface for brokers to integrate their proprietary systems. Transaction volumes are expected to increase, as investors will be able to place orders anytime anywhere through the Internet, cellular phone and other proprietary technology.

The demutualization and merger of the Exchanges was only one of the three prongs of the market reform program in Hong Kong. The second prong is the enhancement of the financial infrastructure in our clearing and settlement system. The last prong of the reform focuses on a complete consolidation and updating of our securities law. These two prongs of the reform program are scheduled to be completed over the next two years.

**What will be the Future of the Securities Market?**

The definition of an exchange is changing as increasing volumes of transactions are executed across electronic networks rather than on traditional trading floors. Advances in technology and strategic alliances among exchanges mean that markets will be linked across geographical boundaries. It will be possible to have a central, global electronic marketplace within the next five years.

In the years to come, most exchanges will be commercial organizations with diverse ownership. It is not unlikely that some exchanges may own, or be owned by, technology or telecommunication companies as there are obvious synergies with these industries. The competition for business by the exchanges will not only be for trading volume and liquidity, but also for the sale of services and data.

Mergers and consolidation of exchanges will take place not only globally but also between traditional exchanges and ECNs. The merger of the Pacific Stock Exchange here in San Francisco with Archipelago is an example of the combined strengths of a traditional exchange with that of an ECN. To survive for the end game, ECNs themselves will also have to transform into other things, either as an exchange, as in the case of Archipelago, or as a broker, as in the case of Instinet. Consolidation of ECNs is also inevitable.

Alliances of cross-border markets will provide seamless 24-hour trading to investors across time zones. Within the next five years, there will likely be three major trading centers in the world linking together regional exchanges: one in North America, one in Europe, and one in Asia. And Hong Kong wants to be the one in Asia. Last week, seven of the top NASDAQ stocks were given trading status on the Hong Kong Exchange. There will be more to come in the near future.

Technology has also transformed the role of the traditional brokers. Real time information on stock prices and other data are available anytime and anywhere. Complex analysis of the market may be done with a click on investors' personal computers. Investors are now able to obtain customized reports on their portfolios through web-based networks. Deregulation of the banking industry in many jurisdictions has enabled banks and other financial institutions to provide customers with one-stop financial services including cash management, portfolio management, direct on-line trading, receiving of dividends, etc. Brokerage firms will have to add value by developing superior risk management systems and providing risk capital in order to compete for customers under such environment.

Investors will be the ultimate beneficiaries of all these changes in the marketplace. Investors will have more choices and information on investment products, easier accessibility to any market they wish to trade on, and better and cheaper services from intermediaries. The new generation of investors will become increasingly sophisticated as

market information becomes widely available. However, the complexity of the new markets also means that investors must know their own risk appetite before entering the market. With sophistication in the marketplace, the demand for improved corporate governance by public companies will also increase.

Securities regulators as well cannot be insulated from all these changes. Whether a demutualized exchange should be regulated as any other listed company, or as a utility, will be a challenge for the regulators. Alliances of exchanges can only be effectively implemented with harmonization of standards and regulatory co-operation among regulators of different jurisdictions. Regulators must also keep up with the sophistication in market technology and new market structure. Enforcement cases will become more complicated as market manipulation and other misconduct are now also conducted on the Internet, making it more difficult to be detected.

Accelerated changes in and development of the marketplace, together with the new population of investors, mean that there will be an increased emphasis on investor education. This is a task which has only recently been undertaken by regulators. The regulator's role is not only to enforce the rules but also to facilitate market development. The challenge is to balance the pressures generated by market participants, with the regulator's desire to ensure stability and integrity in the market. Regardless of any changes, however, the regulator must ensure a fair and transparent market, and a level playing field so that there will be continued confidence in the market of the new era.