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The Outlook for Exchanges in the 21st Century

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Today's Challenging Market Environment

Globalisation and information technology have had a tremendous impact on the financial markets. The revolution in communication technology and the explosive growth of networks and the Internet have eliminated geographic borders and led exchanges to re-examine the way they do business. The traditional role of exchanges as the dominant market for stocks and derivatives has been challenged on several fronts:

- First, advances in information technology have lowered the entry barriers to establishing electronic trading platforms and led to the emergence of new trading systems. In the stock markets, a new breed of Electronic Communication Networks or ECNs has appeared including Instinet, Tradebook, Archipelago and others, capturing significant trading volumes from traditional exchanges and intermediaries.
- Secondly, institutional investors, who manage a growing share of retail and corporate investors' savings and reserves, and large proprietary trading operations, which often have access to vast pools of capital, have become very powerful in their home markets and overseas markets. With access to many markets and the ability to trade directly among themselves, they can choose the best combination of transaction costs, liquidity and price discovery.

- Thirdly, the explosive growth of the Internet, e-commerce and the development of a whole generation of convenient and portable access devices, coupled with the spread of computer literacy, will inevitably lead to a wider and more knowledgeable investor base. Online trading has already had a big impact on our industry and more individual investors will join their institutional counterparts in demanding lower costs and better service.
- Fourthly, listing and trading have transcended national borders. Shares in HSBC and China Mobile have multiple listings in Hong Kong, London and New York. Japanese and Taiwanese stock index futures are among the Singapore exchange's most actively traded derivatives, and American firms are participating in Europe's derivatives markets through computer networks that link their US offices to the LIFFE and Eurex exchanges.
- And fifthly, the development of regional exchanges and global alliances threatens to marginalise small exchanges. Euronext, which was created by the merger of exchanges in Amsterdam, Brussels and Paris, aims to become the first fully-integrated cross-border European market for stocks, bonds derivatives and commodities. And the Globex Alliance, comprising the Chicago Mercantile Exchange and major exchanges in France, Singapore, Canada, Spain and Brazil, offers direct access to the electronically-traded derivatives of its members.

Of all the challenging developments I have mentioned, ECNs are probably the greatest challenge to traditional exchanges. They also provide a great challenge for regulators. Regulators and traditional exchanges have agreed on frameworks for the efficient supervision of markets, market participants, listed companies and the exchanges themselves. Under these arrangements, traditional exchanges are often required to shoulder some regulatory responsibilities and the costs associated with those responsibilities. But the frameworks established for traditional exchanges cannot be applied to ECNs.

Thus, ECNs are free from many regulatory costs and responsibilities, and they are free to cherry pick the best business. There is also a danger that traditional exchanges, disadvantaged by obligations, could see ECNs grab the most profitable businesses and services.

This sort of unbalanced competition leads to a fragmented market environment.

Hong Kong's Response to Today's Challenges

Creation of HKEx

Hong Kong's major response to the challenges of the global markets was the demutualisation and merger of the stock and futures exchanges and the associated clearing houses. The merger was completed in March last year and HKEx was listed on the stock exchange in June last year.

The demutualisation, merger and listing of the exchanges brought many benefits, including the creation of a new corporate culture. HKEx has become a business-driven and service-oriented company with a public duty to act in the best interests of the community and the investing public.

We have streamlined our operations, including human resources, to raise the competitiveness of our markets and we continue to pursue efficiency gains. The merger has also enabled us to adopt a focused technology investment strategy and achieve savings on technology investments by merging market systems. HKEx is now consolidating trading, settlement and clearing functions on platforms that can support straight-through processing.

In addition to producing benefits for HKEx, our strategy yields benefits for our Exchange Participants.

We have upgraded the stock exchange's trading system and are in the process of upgrading its clearing and settlement system. The upgraded trading system, AMS/3, has enabled Exchange

Participants to install more advanced trading systems. It has also enabled them to offer direct online stock trading. Our trading statistics show the upgrade has been very successful. According to the figures for the week of November 12th, more than 70 per cent of the stock exchange's turnover now comes from advanced trading systems introduced after the installation of AMS/3.

Exchange Participants can also now trade all futures and options on a single platform, and next year we will introduce a single derivatives clearing and settlement system to replace our two existing systems.

We also expect our market participants to enjoy long-term cost savings as a result of revised risk management arrangements now under review. Cross-market margining will enable participants to use their capital more efficiently, and it will help improve HKEx's efficiency.

In addition, our market participants now enjoy more product choices. We have further developed our exchange-traded funds market, following the success of the Tracker Fund of Hong Kong. New derivatives have also been introduced, including Mini-Hang Seng Index Futures and Three-year Exchange Fund Note Futures, and we will continue to explore a variety of other new business opportunities.

Greater market transparency and efficiency

The merger and related efficiency gains were important first steps in meeting the challenges of today's global markets. The next steps include greater market transparency and efficiency.

Our upgraded trading systems have made our markets more transparent and efficient and the upgrades to our clearing and settlement systems will bring further gains.

Next year we will introduce the stock exchange's new CCASS/3 clearing and settlement system, which will help us meet our objective of moving from T+2 settlement to T+1 by 2003. The new system will also enable us to move to T+0 when the Hong Kong market is ready.

Another important efficiency issue is trading hours. Our stock market trading hours are among the shortest in the world, and our recent consultation indicated the market accepted the need to shorten the lunch break and extend the afternoon trading session until 6 pm. We are now reviewing all the responses to our consultation and expect to announce the way forward shortly.

Corporate Governance Standards

I will now turn to the challenge of raising corporate governance standards, which is one of the greatest challenges facing exchanges.

HKEx is committed to market quality so we are committed to high corporate governance standards.

Here in Hong Kong and throughout the rest of Asia, corporate governance is influenced by characteristics that set us apart from the markets in Europe and North America. First, family-owned listed companies are a common feature here. Secondly, many of the families that own listed companies are also actively involved in their management.

According to a Hong Kong Society of Accountants report published a few years ago, more than half of Hong Kong's listed companies had one shareholder or family that owned at least 50 per cent of the entire issued capital. The research also showed controlling shareholders tended to appoint family members to manage their listed companies on a full-time basis.

In Europe and the United States, there are very few listed companies that are family-owned and operated. And the top managers are rarely major shareholders in the companies they run.

The family-held patterns in our markets here in Asia have their advantages. Companies that are owned and run by the same family tend to benefit from quick decision-making. Because they are more willing to take risks, deals can be quickly concluded. And the risk taking is rarely reckless since the managers have a large stake in the company. These management advantages are reflected in the fact that family-held listed companies have a record of achieving the fastest growth, bringing substantial benefits to their shareholders.

But there are drawbacks as well. Family-owned and operated companies tend to lack many of the checks and balances that are the hallmark of good corporate governance. They also tend to lack transparency.

Ideally, we should strike a balance and enjoy the best of both worlds.

Good corporate governance is really no more than enlightened self-interest. It is a matter of international record that companies with a consistent record of good governance find it easier to raise capital. And they are able to do so on more favourable terms than companies with a history of mistreating minority shareholders, failing to disclose important information, or of bad governance generally. The price of a company's shares in the secondary market is also profoundly affected by investors' perception of the quality of its corporate governance. A survey of institutional investors last year found that more than 80 per cent of the respondents said they would pay a premium of 18 per cent for shares of companies with sound corporate governance practices.

Bad corporate governance hurts both the companies concerned and the reputation of the markets in which they are listed. The quality of corporate governance in a jurisdiction is closely connected to the development of its securities market and with its international reputation and competitiveness as a financial centre.

Ratings could become vital in raising the standards of corporate governance. Standard and Poor's has introduced a service in Russia that rates companies' corporate governance practices based on ownership structure, transparency, information disclosure and other factors. We have been following the Standard and Poor's initiative with interest and expect similar services will be introduced in Hong Kong.

While there are several ways to advance corporate governance standards, ratings services that encourage voluntary commitments and initiatives to advance corporate governance are the ideal. Corporate governance is among the many issues in which HKEx and analysts have a common interest. There have been encouraging developments, and we hope we can continue working together towards further progress.

Since the early 1990s, the Stock Exchange has undertaken many initiatives to develop high standards of corporate governance.

Main Board initiatives have included regulations governing conflicts of interest between listed companies and connected parties; a Code of Best Practice on the accountability of directors to shareholders; and guidelines on the qualifications and roles of independent non-executive directors.

For GEM-listed companies, the rules require adequate and effective systems of internal control covering financial and compliance requirements. In particular, the companies must have an executive director designated as the compliance officer; a qualified accountant to supervise the accounting and financial reporting procedures and internal control; and an audit committee to be chaired by an independent non-executive director.

The rules and guidelines issued have assisted in raising the status of listed companies in Hong Kong, and we are committed to further strengthening our standards.

As part of a continuing effort to enhance corporate governance standards in Hong Kong, HKEx will consult the market on ways to further raise our standards before the end of the year and we welcome your comments. Your contributions and the contributions of other analysts will help us ensure Hong Kong's stock market remains a high-quality market.

Competition

Another challenge of the global markets is competition. In our case, it is competition from other exchanges in our region and independent trading systems.

Experience has shown that business has migrated and will continue to migrate to markets that offer a high degree of transparency; high corporate governance and accounting standards; balanced market regulations; and secure, flexible, reliable and cost-effective systems for trading, and for clearing and settlement.

We have adopted these market quality benchmarks and are determined to continue meeting them.

Presently, our advantages include the Rule of Law and a well-established legal system, a level playing field, international accounting standards, the free flow of capital and information and a clean government. We also have a sound regulatory regime and sound market practices, which can be amended to meet changing market dynamics.

In addition, we are uniquely situated on the doorstep of one of the world's fastest growing economies, namely, the mainland of China. And HKEx is extremely fortunate that Hong Kong has established itself as a leading international financial centre and major capital formation centre for Mainland China-affiliated enterprises.

We have years of experience helping Mainland China-affiliated enterprises raise freely convertible currency. And we are ready to help the Mainland meet its growing capital needs after it joins the World Trade Organisation (WTO).

Between 1993 and October 2001, HKEx helped Mainland China-affiliated H-share and Red Chip companies raise more than HK$643 billion (over US$82 billion). And these companies play a significant role in our stock market. H-share and Red Chip companies accounted for 26 per cent of Hong Kong's stock market capitalisation at the end of October, and 41 per cent of the stock market turnover in the first 10 months of 2001.

Mainland enterprises are expected to have increased capital needs following China's entry to the WTO. They will also face competitors from around the world who have access to low-cost capital from the international markets. To be able to compete fairly, they will need to have access to their own low-cost capital, and Hong Kong will be there to meet that need.

Globalisation Trends/Challenges

Turning to the challenges of globalisation, as the world appears to become smaller, exchanges must look beyond their home markets for enlarged opportunities.

Apart from being blessed with the unique advantages that have enabled us to develop the Mainland China dimension of our markets, Hong Kong's unique history has given it an opportunity to form strong ties with exchanges in the region and around the world.

In this respect, we have positioned Hong Kong as an integral part of the global marketplace, and established HKEx as an ideal partner for exchanges seeking to form alliances spanning major trading centres in Asia, Europe and the Americas. Our strategy is to become an active and critical partner in a global market group linking the three key time zones for stock and derivatives trading, and providing near 24-hour trading of stocks and derivatives that appeal to international investors. We have participated in discussions on establishing a Global Equity Market for the cross-trading of equities listed on the participating exchanges. And recently, we have been talking with the New York Stock Exchange about an earlier bilateral link within the Global Equity Market framework.

The true globalisation of stock and derivatives trading presents two challenges:

- How do we harmonise regulatory standards; and
- How do we harmonise accounting standards?

HKEx is working to meet both of these challenges. We have signed memoranda of understanding with nearly 40 other exchanges on the sharing of information for market integrity purposes, and we are active participants in the International Federation of Stock Exchanges, the Futures Industry Association and the International Securities Services Association.

We have also been actively involved in the work of the International Accounting Standards Committee. The Committee's objectives include merger of the International Accounting Standards and the United States' Generally Accepted Accounting Principles in five years. I have the honour to serve as a trustee of the Committee. Hong Kong is also represented on its Standards Advisory Council and the Standing Interpretations Committee.

Industry Leadership

Remaining at the forefront of our industry is the last challenge I will look at today.

HKEx is working with Hong Kong's Financial Services Bureau and Securities and Futures Commission, and market participants, to ensure that our markets continue to be among the world's best.

The initiatives have included:

- Reducing transaction costs by lowering stamp duty and deregulating brokerage commissions;
- Working to develop a scripless market;
- Working to revitalise the derivatives warrant market;
- Working to revise the delisting regime; and
- Reviewing the Stock Exchange's Main Board and GEM listing rules.

In addition, studies are now underway on allowing overseas firms to become remote Stock Exchange Participants; and making it easier to list foreign issues.

And we will work with the Financial Services Bureau and the Securities and Futures Commission on streamlining IPO procedures and lowering IPO costs; streamlining or removing limits on derivatives positions; and making it easier for market participants to engage in short selling.

Conclusion

We have an ambitious agenda, but we think that is the only way forward.

Exchanges face many challenges as a result of the globalisation of the financial markets and the widespread use of information technology. I have outlined some of those challenges and explained how HKEx is working to meet them.

I will now conclude with thoughts on the outlook for exchanges in the 21st century.

The outlook is bright if exchanges accept that change is inevitable and seek to take advantage of the opportunities that always come with change. This path requires maintaining competitiveness, raising market transparency and efficiency, establishing high corporate governance standards and the meeting of global market standards.

In HKEx's case, globalisation and the information technology revolution have helped us identify the keys to staying at the forefront of our industry:

- We must continue to be responsive to market needs and changes.
- And we must be vigilant and committed to quality to ensure that we remain competitive.

We hope our efforts and strategies will help strengthen Hong Kong's position as a leading international financial centre. We welcome your comments and suggestions, as well as your encouragement of our efforts.