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8 The Role of The Securities and Futures Commission in Developing Hong Kong's Markets 1992 - 1994

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Introduction

The objective of this paper is to explore in both broad brush and specific terms, some strategic issues relating to market development in Hong Kong from an SFC (Securities and Futures Commission) perspective.

Under S4(1)(j) of the SFC Ordinance, the SFC has a statutory function to encourage the development of securities and futures markets in Hong Kong and the increased use of such markets by investors in Hong Kong and elsewhere.

In relation to its strategic corporate programmes the SFC regards promoting market development as a major pillar, ranking alongside the other major pillar of promoting investor protection and market integrity.

I believe that in terms of Hong Kong's future, market development is important for both offensive and defensive reasons.

Offensively, market development is important because it has the potential to generate higher levels of transaction activity, bring greater efficiency and provide wider product choice - all of which improve the markets' capital-raising function and also contribute to rising real incomes and rising living standards.

Defensively, market development is important to combat growing competition from other financial centres, both within and outside the

East Asia region. Competition from other financial centres becomes more intense with:

- increased mobility of securities and futures trading in primary and secondary markets and fund management;
- increased variety and sophistication of financial products and techniques; and
- increased diversification of asset portfolios by both international and local investors.

Although market development is obviously important, what might not be quite so obvious is what market development means and what role regulators should (and can) play in market development. So I would like to take some time to examine both of these issues.

Market Development Framework

Meaning of Market Development

I regard market development as the process whereby changes are made to the structure of the market or to the way things are conventionally done in the market with the objective of enhancing the performance of the market and thereby the benefits it provides to the community.

Enhanced market performance will become apparent by an improvement in one or more of the following indicators:

- improved costs in the market relative to costs in other markets, for example, as reflected in lower transaction costs;
- improved market quality, for example, as reflected in greater transparency of market prices and better liquidity;
- improved market efficiency, for example, as reflected in shorter times for settlements and registrations;

- improved product range and product suitability, for example, as reflected in a wider range of traded instruments, of collective investments, and of capital raising techniques; and
- increased volumes of activity, for example, as reflected in higher levels of new capital raisings, collective investment sales and secondary market trading.

Improvements in these market performance indicators will generally result in benefits to the community, including reduced cost of capital, job creation, promotion of economic growth and resulting increases in incomes and public revenues.

It is also important to recognise that improvement in a particular market performance indicator can lead to further market developments. For example, enhanced transparency in a market can be a foundation for the success of derivative products trading. Similarly, lowering of transaction costs can attract new primary and secondary market trading activity.

Therefore, when thinking of market development, the SFC tends to think in terms of policies that will enhance market performance and which will become apparent by way of improvements in the performance indicators I have just mentioned. From our perspective, such improvements will tend to come about because of changes to the size of the market, changes to the structure of the market and changes to the "methods" which are used to produce financial services.

The *size of the market* depends largely on the size and growth rate of the population and its economy, the "penetration" of the population and also, of course, whether internationalisation is possible, for example, by providing competitive products or services attractive to foreign populations.

On the *market structure* side, market development might come about as a result of changes to entry conditions (for example, by eliminating regulatory barriers to entry), and by changes to relative costs (for example, by lowering government charges).

With respect to the *methods used to produce financial services*, market development might come about as a result of:

- innovation, technological and others, which improves production and distribution methods;
- changes in pricing policy; and
- changes in business conduct - or the way in which market participants conduct themselves in soliciting clients and in performing their contractual obligations. This determines whether the markets pass what I call the "sniff test", a factor which influences whether investors are prepared to participate in the market, especially international institutional investors.

Thus, from our perspective, these are the dimensions to market development in respect of which we might frame regulatory policies aimed at enhancing market performance.

The Regulator and Market Development

Clearly then, the market development process has many dimensions. But what is the role of the regulator in this process?

At the SFC we start from the proposition that the main impetus for market development must come from the market itself. Under this scenario the role of the regulator is basically to facilitate development initiatives put to it by the market. In this context, there are a number of things the regulator can do.

First, the regulator can establish a regulatory framework and administer that framework in a manner which creates confidence in the systemic stability and the integrity of the market - in other words the regulator can take steps to ensure that the market passes the sniff test which I mentioned earlier. This is essentially a long-run task, the benefits of which accrue to the market over a period of years.

Second, the regulator can relax restrictions which inhibit market development but which are not necessary for investor protection purposes - these are commonly referred to as deregulatory measures.

Third, the regulator can streamline regulatory approval processes and the time taken to process applications to ensure that it provides fast, flexible and responsive services to market participants.

Fourth, the regulator can encourage market bodies to remove protective barriers and to not engage in conduct which inhibits competition.

Fifth, the regulator can assist those who wish to innovate to overcome some of the obstacles which are put in the way by vested interests.

Sixth, the regulator can also provide guidance and assistance to market participants, market bodies and other regulators who wish to pursue market development initiatives but who lack the expertise.

Of course the regulator would always wish to ensure that market development initiatives are designed to ensure the maximum efficiency of the development initiative and its attractiveness and usefulness to local and international market participants.

I think it is self-evident that the need for these various market development regulatory actions will vary according to the market under consideration - that is, whether it is the equities market, the market for corporate control, the debt market, the futures market, the market for packaged collective investment products, the market for investment advisory services and so on. Recognising this, the SFC has designed a market development strategy for the various markets for which it has regulatory responsibility.

I now turn to each of these markets to consider where we stand now and where we might be heading.

The Equities Market

We can think of the equities market in two dimensions, namely the new issues market and the secondary market, although there are obvious linkages between the two. Since 1989, when the SFC commenced operations, there has been significant progress in both of these areas.

Stock Exchange Hong Kong - New Capital Raisings,
Market Capitalisation and Market Turnover 1987 - 1992
HK$ billion

Year	New Capital Raisings	Market Capitalisation	Turnover
1987	49	420	371
1988	20	580	199
1989	22	605	299
1990	24	650	289
1991	45	949	334
1992	117	1,332	701

Although considerable progress has been made in recent years, there is still ample scope for further improvement. As we see it, the strategic challenges are those associated with market expansion, market structure and market innovation.

Market Expansion

It is largely self-evident that expanding the equities market in Hong Kong depends upon both supply and demand factors. The *supply* of securities (which is the mirror image of the demand for funds by enterprises) is very much in a growth phase at present because of the strong economic expansion which is taking place in the region. Strategically, we believe that it is important to forge links between the capital market of Hong Kong and the capital market of China, especially southern China. If these links can be forged there will be important benefits, both for China in terms of increased capital-raising ability, and for Hong Kong in terms of opportunities for investors and intermediaries. It is on this basis that we have developed a framework to enable Chinese securities to be offered and traded in Hong Kong. The first offering took place in June 1993 and trading commenced in July.

Expanding the *demand* for securities involves a two-pronged attack - to increase share ownership by local people and to increase international ownership. The only figures available to me are the results of a survey undertaken by the Stock Exchange of Hong Kong (SEHK) in 1989 which indicated that 9% of the adult population owned local stocks. Although this figure has undoubtedly increased since then, I'm sure there is still considerable room for growth in this element. For example, comparable figures in other countries are 27% for Japan, 21% for the UK and 14% for Singapore. And of course, expanding the demand for Hong Kong securities basically means furthering the process of internationalisation. This is necessary because the opportunities for expanding the local market are limited by Hong Kong's small population, which is growing by less than 1% per annum. This is not a sufficient foundation for sustained expansion of the equities market. We therefore need to develop initiatives which encourage both local people and international investors to participate in the Hong Kong market.

Market Structure

As I mentioned before, entry conditions and relative costs are important considerations in affecting market structure and hence market development.

In Hong Kong, the secondary market for equities is very much two tiered. First, there is the public auction market of the SEHK which operates under a statutory monopoly. It has an active membership of about 500 firms, of whom the top 10 account for about 20% of its turnover, and the top 100 about 70%. Then there is the "hidden" international market, consisting of about 25 international dealers who, on a daily basis, conduct transactions out of Hong Kong with the rest of the world, in non-Hong Kong stocks, equivalent to three to four times the turnover on the SEHK. There is little doubt that with the increasing pace of financial innovation and internationalisation, the SEHK's statutory monopoly will be placed under greater pressure.

An important factor influencing the performance of Hong Kong markets is the cost of trading in Hong Kong *vis-à-vis* other markets, especially those markets which are natural competitors for Hong Kong, namely, Singapore, London and New York. Increasingly, they will become greater competitors as Hong Kong companies, which re-domiciled for insurance purposes, now establish alternative listings for insurance purposes.

As can be seen from the table below, there is every indication that the cost of trading through the Hong Kong market is higher than in the other three markets which are our main competitors. From a strategic point of view this must be addressed.

Dealing Costs
Competing Markets for Trading of Hong Kong Stocks

Country	Minimum Commission Set by Exchange	Stamp Duty	Transaction Levy	Special Levy
	%	%	%	%
Hong Kong	0.25	0.15	0.02	0.03[1]
United States	Negotiable	Nil	Nil	Nil
United Kingdom	Negotiable	Nil[2]	Nil	Nil
Singapore	Sliding Scales[3]	0.100[4]	Nil	Nil

1 To be zero from mid-August 1993.
2 In respect to transactions in Hong Kong Stocks held in nominee name by non-UK entities.
3 Sliding Scale between 1.0% and minimum of 0.5% for dealings transacted in Singapore dollars.
4 No contract stamp duty is payable for transactions made between persons resident outside Singapore and an approved securities company or an approved Asian Currency Unit (an operational entity within a financial institution that has been approved by the Monetary Authority of Singapore to deal in the Asian Dollar market).

Note : All figures shown are for one trade side only.

Market Innovation

The other main challenge in respect of market development is to ensure that Hong Kong does not miss out on the benefits of technological and product innovation which have been such a driving force in the worldwide expansion of the financial services sector. Countries which cannot implement and adapt to financial innovation will be relegated to financial backwaters.

In terms of technological innovation, the challenges immediately ahead of us include the development of an automated securities trading system and the development of an appropriate clearing mechanism for derivatives traded on the SEHK - and in terms of product innovation the introduction of new products and market techniques such as regulated short selling and stock options.

The recent introduction of the securities *clearing system* on a continuous net settlement (CNS) basis is of fundamental importance to Hong Kong's securities markets. It will reduce systemic market risk, it will reduce uncertainty, it will improve efficiency and it will reduce the cost of settling transactions. It will also create capacity for increased turnover and pave the way for the new products that will help to create new business and in turn increase trading volume.

It will reduce systemic risk by the process through which the Clearing Corporation becomes a counterparty to each and every transaction conducted through the Stock Exchange and through the guarantee system which operates for such transactions. In addition, central clearing will limit opportunities for fraud and reduce "lost shares" problems which have been so common in Hong Kong.

Central clearing will also reduce settlement costs and increase efficiency, allowing Hong Kong to handle an increased volume of business without potential disruption of the system as a whole. It should not be forgotten that a huge backlog of unsettled transactions was one of the principal reasons for the four-day closure of the Stock Exchange in 1987.

It will increase market liquidity by giving brokers access to all the quotes on their trading screens (not just quotes from brokers who they know or whose creditworthiness they are sure of), because broker-to-broker counterparty risk will generally be eliminated. For this same reason, there is more likelihood that investors in Hong Kong will get the best price. More importantly, clearing on a CNS basis will allow the market to develop electronically, notably through the development of an automated transaction matching and execution system. In turn, the auto-matching system will allow the development of options and other derivative products which will increase the range of investment instruments available to investors and boost turnover - not only on the Stock Exchange but also on the Futures Exchange.

Thus the successful implementation of the CNS clearing system, which commenced operations in June 1992, is of fundamental importance to the development of the secondary market. So too is the successful introduction of auto-trading. The *auto-trading system*, which is expected to commence late this year, will expand market trading capacity, make trade execution faster and more efficient, and improve market transparency. On-line real-time order entry and execution will eliminate current limitations in telephone-based trading and the resulting market grid locks. This will enable the market to handle higher volume and the system will be able to execute orders according to best price and time priority thereby providing investors with fast access to the best price available in the market. The system will also provide nearly instantaneous reporting of concluded trades thereby providing accurate and timely price information. This latter improvement is crucial to support planned new products.

On the product side, regulated short selling and options on specific stocks are at the top of the innovation list. The proposed introduction of short selling will, for the first time, provide participants in Hong Kong's market with a regulated environment in which to make investment decisions based on perceptions that particular shares will fall rather than rise in value. This will provide a mechanism for supply and demand factors to be reflected in trading decisions and make related pricing of shares more accurate. Short selling will increase market turnover by attracting additional sellers to the market, who in turn become additional buyers when their short positions are covered. Short sellers must borrow shares to settle their trades and this will add new income opportunities for shareholders and intermediaries. Finally, short selling will create new demand for hedging transactions in the futures market and the planned stock options market.

Introduction of options on specific stocks will round-off the range of products offered by the SEHK, thereby bringing it more into line with more mature markets around the world. Stock options will provide investors with opportunities to construct new risk versus reward investment strategies in share trading and to generate additional income. As examples, options will enable investors to hedge against a decline (or rise) in share values thereby motivating purchases and sales of shares that would not otherwise be attractive. In addition, investors can "write" options to generate income and potentially increase overall returns. Accordingly, stock options trading should increase market turnover generally and provide new opportunities for investors and intermediaries.

The SFC and the Equities Market

The emphasis for the SFC is on expanding the market, facilitating necessary changes in market structure and reaping the benefits of product innovation. In the context of these challenges the SFC has and will take steps to:

- improve the regulatory framework and administer that framework in a manner which creates confidence in the integrity of the market;
- relax a number of restrictions which are inhibiting the development of the market;
- streamline a number of regulatory approval processes;
- encourage removal of protective barriers and anti-competitive conduct;
- assist innovators to combat interests who slow down development; and

- provide guidance and assistance in respect of a number of technical matters.

In terms of the *regulatory framework* the SFC had a three-year programme over *1989 - 1991* to fill the various gaps which had been permitted to persist over the years. The aim was to improve our performance in terms of the sniff test, a factor which ranks high in the criteria adopted by international investors in determining their asset allocations as between various markets and by intermediaries in determining whether and to what extent they maintain a presence in the market.

The most important aspects of this programme were as follows:

- Very significant changes were made to the constitutional and governance arrangements of the Stock Exchange over the period 1989 - 1991. These reforms have not only put into place an independent and professional management but have also made the governing council of the Stock Exchange more broadly representative of its broker membership and the various other participants who have an interest in the market - including, of course, representation for listed companies, institutional investors and the investing public.
- In conjunction with the above reforms, in 1991, the SEHK was provided with a statutory duty to maintain a fair and orderly market and to act in the public interest.
- On the risk management side, the SFC developed a regulatory framework, consisting of a mix of statutory and non-statutory requirements, to facilitate the implementation of central clearing for securities transactions. This was ready for the start of the system in June 1992. As part of this process the Commission developed a regulatory framework which included the introduction of broker fidelity insurance and monthly financial reporting for SEHK members as well as an increase in the compensation fund payment limit from $2 million to $8 million. It also developed a framework in which stock borrowing and lending transactions could take place.

- September 1991 saw the enactment of a Securities (Disclosure of Interests) Ordinance which requires major shareholders, company directors and other insiders to disclose publicly their holdings and dealings above certain levels. The purpose is to increase market transparency.
- A new Securities (Insider Dealing) Ordinance also came into force in September 1991. It increases significantly the penalties for this type of market abuse.
- A new set of Stock Exchange listing rules was introduced in 1989 and revised again in 1990. The rules established requirements in line with international standards and were accompanied by a progressive strengthening of the Listing Division. This was followed at the start of 1992 by the establishment of a newly constituted Listing Committee.
- In addition to the above, the Commission also assisted in developing a regulatory framework to facilitate the offering of PRC "B shares" securities in Hong Kong. These are contained in Prospectus Guidelines which were issued by the Registrar General in July 1992.

For the period *1992 - 1994* we are taking further steps to improve the regulatory framework governing the equities market. For the SFC, this will involve some shift in focus away from regulatory reform more towards effective regulatory enforcement. In particular, we will have to step up our enforcement activities in such areas as false statements made in disclosure documents and at the same time seek to curb practices used by some controlling shareholders and managers of listed companies which are of concern to minority shareholders.

Of course this shift in focus does not mean that reform of the regulatory framework will be completely neglected. At present the most important matters under consideration in respect of the equities market are:

- Finalising a regulatory framework in which auto-trading can take place. Our goals include client precedence which involves fair "queuing sequences" and "best execution" for clients' transactions, which may be controversial.

- Implementing the regulatory framework in which regulated short selling can take place. The controversial issue relates to the speed of reporting completed transactions (and once auto-trading is implemented, the speed of reporting transactions not executed through the electronic trading system).
- Developing a regulatory framework for stock options to be traded on the SEHK.
- Revamping the compensation funds to increase the certainty surrounding eligibility for payment, to increase the pool available for compensation, to enhance the efficiency of the system, and to delegate more administrative function to SEHK.
- Reviewing the various financial reporting and other disclosure requirements which are contained in the Listing Rules and the Companies Ordinance.
- Reviewing the Prospectus Guidelines developed in 1992 for foreign issuers, especially PRC enterprises. This will occur after we have gained some experience in administering the guidelines.
- Considering minimum statutory obligations for listed companies covering such matters as "full, true and plain" disclosure requirements, supplementary information disclosure, true and fair presentation of accounts and liability of advisers.
- Reviewing the Securities (Disclosure of Interests) Ordinance with a view to closing loopholes (and eliminating unnecessary procedures).
- Completing our review of current legislation concerning distribution of securities, with particular emphasis on removing ambiguities associated with the concept of "offer to the public".

At this juncture I should mention that since 1990 the Commission has been engaged in a major exercise, which, for want of a better phrase, we have dubbed "Rationalisation of the Legislation". This exercise originates in the Securities Review Committee recommendation that there was "a need to undertake a comprehensive review of the legislation to ensure that it deals adequately with recent market developments and modern trading practices". The primary objective of the exercise is to consolidate, update, rationalise and simplify as many of the SFC Ordinances covering as many of the markets which the SFC regulates as possible. The rationalisation exercise is thus fundamentally aimed at enhancing the regulatory framework. It is planned to submit the first draft of a White Bill to the Financial Services Branch later in 1993 and to undertake follow up work throughout 1994.

Turning now to *deregulatory measures*, the period *1989 - 1991* saw a number of important initiatives to facilitate the development of the equities market.

The Commission implemented the Hong Kong Code on Share Repurchases, to enable, for the first time, share repurchases by public companies in Hong Kong. Essentially, the Code requires share repurchases to be effected by way of a general offer to all shareholders, or in accordance with prescribed exemptions from the general offer rule. Exemptions include share repurchases made through the facilities of the Stock Exchange in accordance with amendments to the listing rules. In general terms, these amendments permit a listed company to make monthly share repurchases of up to 25% of the total number of shares traded on the Stock Exchange in the immediately preceding month subject to an annual share repurchase limit of no more than 10% of the company's outstanding shares.

Following the failure of a major rights offering in late May 1989, the SFC urged the Stock Exchange to re-examine the financing requirements relating to rights issues, including the question of pre-emptive rights, mandatory underwriting, the 10% director's mandate, and limitations on warrants. As a result of the Exchange's review, new Listing Rules in this area were introduced on 1 June 1990 which:

- substantially relaxed the mandatory underwriting requirement;
- increased the director's mandate to 20%; and
- relaxed restrictions on warrants.

Another area where the SFC perceived scope for improvement was the entry requirements for new listed companies under the SEHK Listing Rules. The SFC encouraged the Stock Exchange to relax certain of the qualifications for listing, including in particular the five-year trading record requirement. The SFC suggested that a three-year trading record was sufficient, with the Exchange having a discretion to accept a shorter period of two years (or less) for a company with a minimum asset value, which could demonstrate that it had adequate working capital to meet its needs and a sound management. The Exchange included these suggestions in its Six-Monthly Review of the Listing Rules which were approved by the Commission in February 1991.

Over the period *1992 - 1994* we are continuing to examine deregulatory measures which will facilitate the development of the new issues market with the aim of ensuring that financing mechanisms available to Hong Kong listed companies fully meet international standards in terms of flexibility, speed and cost-effectiveness.

A further way the SFC can assist market development is to take steps to *streamline regulatory processes*. For the primary capital market, the period *1989 - 1991* saw the focus on measures to eliminate duplication of regulatory effort.

The SFC completed a review of the Stock Exchange's listing-related functions which paved the way for the further devolution from the SFC to the Stock Exchange of the administration of Listing Rules, accompanied by certain new checks and balances to ensure consistent long-term impartiality and professionalism in the performance of this function and to permit continued effective oversight by the SFC after it relinquished its day-to-day involvement. This devolution was completed by the end of 1991.

Separately, and to reduce further the existing overlap between the Registrar General, the SFC and the Stock Exchange, the SFC prepared a proposal to facilitate a transfer of the Registrar General's responsibility to vet prospectuses in relation to shares and debentures of companies registered under the Companies Ordinance and companies incorporated outside Hong Kong. The Stock Exchange has now assumed responsibility for vetting prospectuses in relation to shares or debentures of listed companies and the SFC has responsibility for vetting prospectuses for unlisted companies.

In addition to the above, the Commission devoted considerable resources to streamlining procedures for the introduction of the Securities (Disclosure of Interests) Ordinance in September 1991. To assist market participants, the Commission designed a special set of forms for use on a voluntary basis, a development which is widely accepted throughout the market.

Finally, as part of the development of the regulatory framework for central clearing, the Commission included a provision which enables the SFC to declare certain rules of the Clearing House as rules which do not need SFC approval on amendment.

Over the period *1992 - 1994* we are continuing to implement measures to streamline the regulatory approval process to assist the development of the markets. At present the most important matters under consideration are:

- to amend the legislation to enable the SFC to declare certain rules of the SEHK as rules in relation to which amendments do not have to be approved by the SFC;
- to make uniform the various rule submission and approval processes from the Exchange and the Clearing House; and
- to review procedures under the Securities (Disclosure of Interests) Ordinance with a view to further streamlining compliance procedures for market participants.

Another category of market development measures consists of *removing barriers to competition*. By the standards of Asian equities markets, Hong Kong is probably the most open, and the most free from barriers which restrict competition. However, there are a number which warrant consideration.

In terms of the primary market, the Commission has pressed the SEHK to do away with the rule which mandates that rights issues be underwritten. The Commission takes the view that this should be a decision for a company's directors. The SEHK has responded by partially eliminating the requirement, but it has not yet been abolished.

During 1992, pressure mounted in the Hong Kong broking community to increase minimum commission rates. The Commission takes the view that an "across the board" increase in minimum rates is anti-competitive because it restricts brokers from competing on a price basis. The Commission will maintain this stance, which is an element of an overall market development initiative to reduce transaction costs. Other elements of this initiative for *1992 - 1994* include:

- further submissions to the Financial Secretary recommending that stamp duty on securities transactions be reduced (this follows earlier submissions to remove stamp duty on stock borrowing and lending, to remove transfer deed duty on securities transferred within the central clearing system and to reduce stamp duty on market transactions - duty was reduced from 0.6% to 0.5% in 1991, from 0.5% to 0.4% in 1992 and from 0.4% to 0.3% in 1993);
- further reviews of the SEHK transaction levy with the aim of achieving additional reductions from 1 July 1994 (the levy was reduced from 0.025% to 0.02% from 1 July 1993); and
- submission to the Financial Secretary recommending that the "Special Levy" on stock and futures market transactions be suspended (this has been accepted and is likely to take effect from mid-August 1993).

Given the reductions in stamp duty over the last three years, it would be unrealistic to expect that further reductions could be made without some move towards more competitive commission rates.

A more controversial matter relating to competitive issues is the statutory monopoly which has been granted to the SEHK by virtue of its exclusive right to establish, operate and maintain a stock market in Hong Kong. With the changing nature of stock markets (especially the development of cross-border screen trading facilities) and the changing nature of instruments which are traded using screen facilities (especially the increasing blurring of the traditional distinction between equities and other tradeable instruments) it will be necessary for the Commission to focus on how to cater for these new technical developments in the nature of the instruments being traded and the systems being used to trade them without altering in any significant way the rights which the SEHK currently enjoys.

Another form of initiative which the Commission can take to develop the equities market is to assist innovators to *overcome opposition from traditional interests who oppose change.* Throughout *1989 - 1991*, the Commission devoted considerable energy to breaking down opposition to a number of important initiatives, in particular the development of the central clearing system, stock borrowing and lending, short selling, broker fidelity insurance and auto-trading. The Commission also encouraged the SEHK to take steps to list "covered" warrants which were being issued by international financial institutions on some Hong Kong listed securities. It is clear that progress on important initiatives such as these depends significantly on the extent to which competing and vested interest groups are prepared to subordinate their individual interests to those of the market as a whole and to recognise their own and Hong Kong's longer term interest in seeing the market as a whole grow. Over *1992 - 1994* we will continue to focus our energies on convincing certain market participants of the benefits of regulated short selling, auto-trading and traded stock options. Also we will continue to press share registrars to implement procedures to reduce the time taken to register transfers of share ownership.

A further set of development initiatives for the equities market undertaken by the Commission concerns the provision of *guidance and assistance on technical matters.* During *1989 - 1991*, most of our attention was devoted to assistance in relation to the development and on-going review of the listing rules, central clearing, stock borrowing and lending, short selling and auto-trading. For *1992 - 1994* the focus has shifted to the technical aspects of traded options and to the trading of PRC issues in Hong Kong. The SFC will also provide considerable assistance to the PRC to enable it to develop an appropriate regulatory structure for its newly emerging securities markets.

The Market for Corporate Control

The market for corporate control consists of the various sets of mechanisms which enable the control of a corporation to pass from one group to another, or which enable a controlling group to extend/ diminish their control. From a regulatory point of view there are basically two sets of issues, one concerning market development and the other concerning market integrity.

The former set focuses on whether the framework for regulating takeovers and mergers operates in a manner which inhibits the level of takeover and merger activity that is necessary to enable the economy to grow and to adjust to structural change. I am not aware of any problems in Hong Kong in this respect, and so it is not an issue with which we have had to concern ourselves.

The latter set of issues focuses on whether the framework for regulating takeovers and mergers operates in a manner which is generally perceived to produce a "fair result" in terms of sharing out the premium for control. If it does not, then the integrity of the securities markets will be at risk, and will discourage minority shareholders, both institutional and small, from participating in the markets.

The SFC has been very much aware of this latter set of issues, and over the period *1989 - 1991* expended considerable effort in enhancing the *regulatory framework* for takeovers and mergers. A completely revised Code came into operation in April 1992. However, a number of important and controversial issues relating to the regulation of takeovers and mergers remain outstanding and will be addressed over the planning period *1992 - 1994*. As these are essentially investor protection issues I do not propose to deal with them here.

The Debt Market

The development of a significant medium-term Hong Kong dollar debt market is another important issue in the context of market development. Although the short-term government debt market has grown rapidly in recent years, the medium-term market has not. Despite some bond issues by top quality international borrowers such as the World Bank, the Asian Development Bank, the International Finance Corporation and General Electric Capital Corporation, the medium-term debt market consists mainly of issues of certificates of deposit issued by banks and two-year notes issued by the Government.

A number of factors have contributed to the relatively small size of this market compared to the equities market. They include the very low level of government debt, the illiquidity of many issues, the general preference of retail investors for equity, the limited demand from institutional investors for longer-term fixed-rate Hong Kong dollar paper and an acute shortage of swap counterparties.

However, Hong Kong does have the potential to grow as a debt-fund raising and secondary market trading centre because of the convertibility of the Hong Kong dollar and the absence of foreign exchange restrictions, and the large number of financial intermediaries. Such potential may start to emerge over the next few years because major infrastructure projects and the requirements of Mainland enterprises should increase the supply of instruments. Also the more rapid growth and funding of pension and provident funds, in response to new legislation, should increase demand from institutional investors in Hong Kong for medium-term debt instruments.

The SFC and the Debt Market

The ability of the SFC directly to influence these developments is circumscribed by the limited role it has to play in the actual regulation of issues of debt market instruments under the provisions of the Protection of Investors Ordinance (PIO).

It has no role, for example, in the Hong Kong Government's Exchange Fund Bills programme, which came into existence in March 1990 with the first issue of Hong Kong dollar Bills of 91 days maturity in book entry form. That programme, now covering Bills of maturities of 91, 182, and 364 days, was introduced for reasons of monetary policy. At the end of the first quarter of 1992, the programme had $14.6 billion in Bills outstanding, with average daily turnover of $5 billion to $7 billion. It is not within the ambit of the SFC's regulatory net because securities issued by the Government are exempted from the PIO.

The SFC's role is primarily that of regulator, and is effected by means of "pre-vetting" offer documents for certain classes of capital market instruments, prior to authorising their issue to the public. These include certificates of deposit, bills of exchange, promissory notes and other forms of what may loosely be described as commercial paper.

Although the SFC's role in the debt market is primarily one of regulator, it is still able to facilitate development of the market not only by providing an efficient and quick response to documentation of capital market instruments submitted to it for authorisation, but also by recommending to the Government the elimination of statutory restrictions on capital markets issues where it considers the restrictions are unnecessary for the protection of investors.

Over the period *1989 - 1991* the SFC sponsored a first tranche of *deregulatory amendments* to the PIO to liberalise certain controls over the issue of debt instruments. The effect of these amendments was to remove certificates of deposit issued by authorised institutions in Hong Kong (banks, restricted licensed banks and deposit-taking companies) from the purview of the Commission because these institutions are subject to the prudential supervision of the Hong Kong Monetary Authority. Exemptions were also created for commercial paper issued by certain exempted bodies and multilateral agencies provided they met certain criteria.

Over the period *1992 - 1994* the Commission will continue to press for further deregulation in this area. It has prepared proposals to amend the Gambling Ordinance and the PIO to overcome a number of technical matters which are creating problems for certain issuers of capital market instruments. These include further easing of those institutions qualifying as exempt bodies, removal of duplication between the SFC and SEHK in relation to certain matters and extending the exemption which exists for offers of securities to professionals to offers of investment arrangements to professionals.

The Futures Market

As is well known, the Hong Kong futures market has faced an uphill battle to re-establish itself since the disaster of October 1987. That battle is not yet over, as evidenced by the level of turnover. Nevertheless, over the last few years, there has been a steady and encouraging increase in the Hong Kong Futures Exchange's main contract - Hang Seng Index (HSI) futures.

Hong Kong Futures Exchange - Turnover, 1987 - 1993

Year end 31 March	Hang Seng Index	HIBOR	Soybeans	Sugar	Gold	Total
1987	1,556,899	-	368,703	312,459	6,475	2,244,536
1988	2,921,698	-	628,086	236,899	4,602	3,791,285
1989	149,548	-	307,675	190,123	1,920	649,266
1990	222,979	31,803	137,844	129,150	996	552,772
1991	302,996	24,622	92,110	94,131	984	514,843
1992	521,977	298	19,368	28,281	996	570,920
1993	1,433,753	145	-	1,546	984	1,436,428

Note: The soybean contract was suspended in 1992.

It is evident that the strategic challenge facing the Hong Kong Futures Exchange (HKFE) is to expand the market to a self-sustaining level sufficient to provide it with both credibility and financial stability. It is unlikely that this will be achieved without some changes to market structure as well as product and technological innovation.

In this respect, a major step forward took place on 5 March 1993 when a cash settled option on the HSI commenced trading. To facilitate this product the exchange introduced enhancements to its clearing procedures utilising margining and risk management systems purchased from the Options Clearing Corporation in the United States. The contract has made a promising start, trading an average of approximately 600 lots per day.

The SFC and the Futures Market

In order to support the Hong Kong Futures Exchange in its market development efforts over *1989 - 1991* the SFC took steps to:

- improve the regulatory framework;
- streamline regulatory approval processes;
- provide technical assistance; and
- reduce statutory transaction costs.

In terms of the *regulatory framework* the SFC encouraged the Hong Kong Futures Exchange to reform its board structure to introduce non-broker members. The SFC also introduced an appropriate regulatory framework for the new clearing system and to help *streamline the regulatory approval process* the Commission and the Exchange developed a Memorandum of Understanding to delineate regulatory responsibilities.

The SFC provided the Exchange with considerable *technical assistance* in restructuring the clearing system and in designing its new products (HIBOR, HSI-sub-indices, and stock index options). The SFC also provided the Exchange with a Chief Executive for six months.

In respect of costs, the SFC supported the reduction in the "life boat" levy on HSI futures contracts from $30 to $5, arranged for a waiver of the transaction levy for the first six months of trading for any new product and made submissions to Government to reduce the transactions levy from $2.50 to $2.00 with effect from 1 July 1993.

For the period *1992 - 1994* we are focusing on the same categories of measures as in the previous planning period. Under the heading of improving the regulatory framework we will:

- introduce statutory duties for the HKFE along the same lines as those applicable to the SEHK;
- revamp the compensation fund to increase the certainty surrounding eligibility for payment, to increase the pool available for compensation, to enhance the efficiency of the system, and to delegate more administrative functions to the Exchange;
- introduce broker fidelity insurance; and
- bring the Clearing Corporation for the HKFE into the regulatory framework.

As far as deregulatory measures are concerned, we will consider whether it is possible to move to some form of net margining system without adverse consequences for systemic risk, and in terms of streamlining regulatory approval processes, the SFC will:

- request the Executive Council to delegate to the SFC the power to approve changes to the Schedule of products which can be traded on the Exchange;
- introduce legislation to enable the SFC to declare certain rules of the Exchange to be rules which do not need SFC approval; and
- make uniform, rule submission procedures for both the Exchange and the Clearing House.

The SFC will also provide the Exchange and the Clearing House with technical assistance in developing new clearing methodology, screen-based trading and margin-linking processes.

The Market for Collective Investments

The location in Hong Kong of the principal regional offices of most of the major international fund managers is an important advantage which needs to be preserved both for its own sake and because of the head start it should give to Hong Kong in developing regional products and trading activities.

Hong Kong's status as an international fund management centre is clearly illustrated by the table below relating to funds authorised for distribution in Hong Kong.

Authorised Funds by Jurisdiction (%)

	31.03.90	31.03.91	31.03.92	31.03.93
Jersey	21	14	10	8
Luxembourg	21	29	30	31
Hong Kong	19	15	12	8
Guernsey	12	13	14	15
Cayman Islands	10	8	12	13
UK	6	10	9	6
Bermuda	5	5	6	7
Others	6	6	7	12
Total	**781**	**920**	**856**	**901**
Estimated NAV (US$ m)	36,234	25,777	28,768	28,655

This process of internationalisation has been facilitated by Hong Kong's regulatory system which has adapted to the problems created by cross-border offerings of securities.

In terms of development, the industry is at a major crossroad. The number of funds authorised for distribution in Hong Kong reached a high on 31 December 1990 at 936, but has declined since then. This trend is largely the result of rationalisation by fund management companies because over two-thirds of de-authorised funds had never been launched in Hong Kong or were no longer being marketed.

The major challenge for the industry is not so much on the product development side, but is on the distribution side. So far the industry has not achieved significant penetration of the Hong Kong population - less than 2% is a statistic that is often quoted. Part of the problem lies in the state of the investment advisory industry which lags behind that of other countries with a similar volume and variety of products on offer. The solution to this problem is basically in the hands of the industry, as there is little a regulator can do, other than perhaps to participate in a broad-based education programme.

The SFC and the Market for Collective Investments

You might recall that when the SFC commenced operations on 1 May *1989*, the unit trust industry faced a number of serious problems on the market development side:

- there was a seemingly long and interminable queue of applications waiting to be processed;
- there were tight additional regulatory restrictions on money and capital market funds;
- fund managers were unable to market warrant funds in Hong Kong, despite the fact that some of these were amongst the top performers in the performance league tables;
- there were ambiguous restrictions on the levels of options and warrants permitted for non-warrant funds; and
- the Unit Trust and Mutual Funds Code was decidedly out of date and long overdue for a comprehensive review.

We immediately set to work to tackle these market development issues.

First, the queue of applications was eliminated. On 1 May 1989 there were 58 live applications in the queue, of which 18 were left over from 1987, 34 were left over from 1988 and six were from 1989. By early September 1989 the number of active applications had been reduced from 58 to nine and of those nine all were being worked on by SFC staff. So, since September 1989 the industry has been able to operate in the certainty that any application would be taken up by the Commission within a week or so and processed within 21 days. In other words, since September 1989 we have been able to reduce average authorisation times from over one year to about three weeks.

This problem was tackled by streamlining procedures for dealing with applications from a number of offshore jurisdictions. On the basis of the regulatory framework in the home jurisdiction together with certain undertakings given by the management company the SFC was able to introduce a system of standard waivers. This increased the speed at which applications for authorisation were processed and reduced costs for applicants. The jurisdictions for which standard waivers are now granted include the United Kingdom, Luxembourg, the Channel Islands, the Isle of Man, the Republic of Ireland and Bermuda.

Then, the money and capital market guidelines were comprehensively reviewed with the result that all but one of the additional requirements previously placed on capital market funds were abolished. Consequently, capital market funds are no longer subject to a minimum subscription requirement, a liquidity requirement, special investment limitations and advertising restrictions. This places them on the same footing as equity funds except that their borrowing is restricted to 10% of the fund's net asset value whereas for equity funds the figure is 25%. The guidelines on money market funds remain in place but a number of restrictions were eased, for example the liquidity requirement for money market funds was abolished. The most significant remaining restriction for money market funds is the $50,000 minimum deposit for funds denominated in Hong Kong dollars which was retained because of Government submissions that its abolition would impede their ability to conduct macroeconomic monetary policy.

Next, the marketing of warrant funds was allowed as from November 1989 and at the same time the SFC decided that the permitted level of options and warrants for non-warrant funds could be increased from 10% of the value of the underlying securities to 15% of the market value of the funds.

Through 1990 and 1991 the SFC focused its attention on the final major outstanding issue, which was the review of the Code. Following extensive public consultation the revised Code was published and came into effect on 1 September 1991. The overall thrust of the Code was deregulatory and it was revamped considerably to make it user-friendly.

Chapter 8 of the revised Code deals with Specialised Schemes such as Unit Portfolio Management Funds, Money Market Funds and Warrant Funds. During 1991 the Committee on Unit Trusts expanded the range of schemes which might be authorised to include Leveraged Funds, and more recently guidelines for authorisation of futures and options funds have been added to this category.

The problems faced by the unit trust industry were also present, but to a lesser degree for companies wishing to market investment linked life insurance products and pooled retirement funds. Again, there was a queuing problem but there was no regulatory framework to guide promoters. The backlog of applications was eliminated by October 1989 and a Code on "Investment Linked Assurance and Pooled Retirement Funds" was published in 1991.

Another form of collective investment which is offered to the public in Hong Kong consists of what are known as "Immigration Linked Investment Schemes". They are basically offers of securities or investment arrangements which have linked to them some form of scheme which enables the investor to obtain "passport rights" in the country of origin. The Commission developed a regulatory framework for the offering of such schemes and published a Code in 1990 which was revised in 1992.

Thus, in terms of the market for packaged collective investment products, the SFC focused mainly on establishing a regulatory framework, relaxing unnecessary restrictions and streamlining application time. I think that for the foreseeable future we have now completed most of the proactive tasks we can initiate to facilitate the development of this market. Much of what we do from now on will be more in the form of responding to industry initiatives.

The one exception of course, is consideration of the $50,000 limit on Hong Kong dollar denominated money market funds. This is basically a question of timing.

The Market for Dealing and Advising Services

The market for dealing and advising services is unlike the other markets I have referred to in that it relates to the demand and supply for the services of financial intermediaries rather than the demand and supply for particular securities, investment products or futures contracts.

In making choices between one intermediary *vis-à-vis* another, investors will take into account such things as the price of the services, the quality of the services and their perception of the integrity (financial and ethical) of the intermediary providing the services.

Since 1989 the total number of persons registered with the Commission has increased gradually each year, although most of the growth has taken place on the securities side, particularly dealers' representatives, investment advisers and advisers' representatives. This pattern of growth is not surprising as the demand for intermediary services is basically "derived" from the demand for the securities and futures products for which they provide services.

Number of Registered Dealers and Advisers as at 31 March

	1989	1990	1991	1992	1993
Securities					
Dealers	1,178	1,209	1,297	1,256	1,333
Dealers' Representatives	3,263	3,701	3,887	4,012	4,428
Advisers	853	999	1,078	1,158	1,209
Advisers' Representatives	445	573	739	830	990
	5,739	**6,482**	**7,001**	**7,256**	**7,960**
Commodities					
Dealers	247	261	263	269	286
Dealers' Representatives	957	1,089	980	934	1,143
Advisers	96	112	112	108	108
Advisers' Representatives	8	21	18	17	22
	1,308	**1,484**	**1,373**	**1,328**	**1,559**
Total	**7,047**	**7,966**	**8,374**	**8,584**	**9,519**

The SFC and the Market for Dealing and Advising Services

We have given considerable thought to measures that might be introduced by the SFC to develop the market for dealing and advising services, but have concluded that it is not all that clear what a regulatory authority can do to develop this aspect of the industry. We have focused our attention on:

- improving the regulatory framework;
- streamlining regulatory approval processes; and
- encouraging the development of professional education programmes.

Over *1989 - 1991* the SFC *improved the regulatory framework* by implementing a proactive licensing system based on newly established criteria to determine the "fitness and properness" of registered persons. The purpose was to enhance the integrity and image of the industry. Consistent with this approach, the SFC encouraged the development of standard client agreements and risk disclosure documents for securities and futures dealers to assist the public when establishing a relationship with a dealer. Over this period the Commission also spent considerable time developing a new framework for capital adequacy of dealers to reflect more properly the overall risks associated with dealing. Included in the framework are proposals to ensure that advisers who handle clients' money are subject to appropriate requirements, including the keeping of segregated accounts and holding sufficient professional indemnity insurance.

During this period action was also taken to *streamline regulatory approval processes*. The most important of the measures include:

- abolition of the annual renewal system for licensing;
- introduction of a temporary licensing system to enable visiting intermediaries who are licensed with a recognised overseas regulatory authority to distribute (authorised) collective investments at "Investment Exhibitions"; and
- introduction of a set of procedures to minimise the licensing implications of a transfer of employment by an intermediary.

The Commission has also encouraged and participated in the development of a *professional qualifications* programme for the securities industry by the SEHK. A stockbroker's training and examination programme commenced in 1989 and was eventually given recognition by the SFC in October 1991 as a professional examination under the "fit and proper" criteria.

For the period *1992 - 1994* the Commission is taking steps to improve the regulatory framework by:

- developing and implementing codes of conduct for dealers and advisers;
- implementing the new financial resources rules, the framework for which was developed over the period 1989 - 1991; and
- revamping the dealer deposit scheme and considering imposing a requirement for mandatory fidelity insurance.

Also, we have developed a questionnaire, which has been sent to all registered investment advisers with the purpose of building up an information base on the advisory industry. It covers such things as nature and scope of business, mode of remuneration, organisational and operational structure, and financial resources and business practices. We hope that this information base will assist us to develop appropriate policies for the industry over the next few years.

Conclusion

In this paper I have sought to explore in both broad brush and specific terms some strategic issues relating to market development in Hong Kong from the SFC's perspective. Given its statutory function to encourage the development of the securities and futures markets in Hong Kong and their increased use by investors, the SFC places market development high on its agenda. I have examined what the SFC can do to assist in and promote market development, what the SFC has done in the past in this regard, and what it plans to do in the near future. But the paper also points out that the main impetus for market development must come from the market itself, and that the role of the regulator is basically to facilitate the development of initiatives put to it by the market. The challenge for the future is to ensure that the SFC and market participants work together to ensure that Hong Kong consolidates and enhances its position as a leading international financial centre.