

Establishment of the Securities and Futures Commission - the Davison Report

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27 May 1988

The Closure of the Stock Exchange of Hong Kong¹

On Monday, 19 October 1987, following three successive days' decline on the New York stock market, which was a 10.5% fall in the Dow Jones Industrial Average, the Hong Kong stock market fell by about 11.1% on a turnover of \$4,176 million. In Japan, the Nikkei fell by 2.4%, while in London, the Financial Times 30 fell by 10.1%, in Australia, the All Ordinaries Index fell by 3.7% and in New York, the Dow Jones fell by 22.6%, its largest ever percentage one day fall.

The Hong Kong stock market, along with other world equity markets, had been on a strong uptrend for some time. Put into a world context, the comparative figures were as follows:

Index	1987 Peak	Date	Level on that date in 1986	Percentage increase in 12 months
Financial Times 30	1,926	16 July	1,306	47%
Dow Jones	2,722	25 Aug	1,872	45%
Nikkei	26,646	14 Oct	17,318	54%
Hang Seng	3,950	1 Oct	2,090	89%
Australia All Ordinaries	2,306	21 Sept	1,211	90%

¹ Extracted from Appendix 1 of the Davison Report.

The Hang Seng Index (HSI) had moved from 2,540 on 2 January 1987 to an all time high of 3,950 on 1 October 1987, i.e. a rise of 1,410 or 55% in the space of nine months.² Turnover had almost trebled during the period.

The HSI futures market recorded a similar strong uptrend during that period. From its launch in May 1986, when 31,070 lots were traded, turnover grew at an increasing pace so that by September 1987, 601,005 lots were traded, i.e. an increase of nearly 2,000% in 17 months.

In the light of the reversals on the major overseas equity markets during the preceding week, the Hong Kong Futures Exchange (HKFE), prior to commencement of trading on 19 October 1987, imposed a spot month limit of 180 points up or down per half-day session and 150 points up or down per half-day session on the two longer months. At the same time, the clearing house, ICCH (Hong Kong) Ltd., made an intra-day margin call at midday on all members holding long positions - 49 in total - for one additional deposit of \$8,000 per lot.³ The deposit was increased to \$10,000 per lot at 3:00 p.m. the same day. Contracts for all three months traded limit down for the day.

When news of the record fall in New York reached Hong Kong in the early hours of 20 October 1987, the Chairman of the Stock Exchange of Hong Kong Ltd. (SEHK) informed the Financial Secretary of his intention to seek the Exchange Committee's agreement to suspend trading for the rest of the week. Despite doubts expressed by the Administration regarding the length of the intended closure, the Committee, at an emergency meeting held at 8:30 a.m. in the morning, decided to suspend trading for four days under its general power to administer affairs of the Exchange (Rule 203) and under the specific power to suspend all trading activities in the event of an emergency (Rules 204(11) and 572).

² Base date for the HSI: 31 July 1964 at 100 points.

³ The total amount of intra-day margin called was \$192 million. This was fully met except for \$7 million, of which \$4 million was received the following day.

The SEHK Committee's decision to suspend trading for four days as publicly announced was based on the following: concerns regarding the possibility of panic selling, confusion and disorder in the market, the liquidity of members, the possibility of bank runs and the uncertainty caused by the settlement backlog (then estimated at over 250,000 deals, equivalent of a full week's trading).

Following the SEHK's decision to suspend trading for four days, the HKFE also decided on 20 October to suspend trading of HSI futures contracts for the same period. Later in the day (20 October 1987), the Chairman of the HKFE informed the Secretary for Monetary Affairs that, as a result of clients walking away from their commitments, futures brokers were having difficulties in margining contracts.⁴ The Chairman pointed out that there were serious doubts about the ability of the Hong Kong Futures Guarantee Corporation (FGC), which had a capitalisation of \$15 million and accumulated reserves of around \$7.5 million, to meet its obligations.

The Hong Kong Unit Trust Association also indicated (on 20 October 1987) that many unit trusts had been left exposed by the decision to suspend trading on the two Exchanges and that redemption of units was likely to be suspended in the interim.⁵

As the HKFE could not resume trading without some reinstatement of the guarantee, the Secretary for Monetary Affairs held a meeting in the morning of 21 October with the Chairman of the FGC and representatives of the major futures brokers to consider the matter. At the meeting, the brokers stressed the gravity of the situation and pointed out that, of the approximately 40,000 outstanding HSI futures contracts, a very large number of the short positions were held by arbitrageurs and hedgers, who were mainly overseas institutional clients. The arbitrageurs' and hedgers' short positions were held against physical stock holdings, estimated to be in the region of between

⁴ Of the \$382 million margins called, based on 19 October's limit down prices, \$108 million (or 28%) remained outstanding at the day's close.

⁵ In the event, all but two of the unit trusts companies suspended redemptions during that week.

\$5 billion to \$6 billion. The brokers added that, if the futures markets collapsed or if any attempt was made to "ring out" contracts at an arbitrary price, these people would be forced to liquidate their physical holdings. This would create a massive downward pressure on the market, cause major economic disruptions and serious damage to Hong Kong's reputation as an international financial centre.

To resolve the problem, the brokers proposed a \$2 billion capital injection into the FGC: comprising \$1 billion from the Government, \$0.5 billion from the shareholders of the FGC and \$0.5 billion from the major futures brokers. This would cover a 1,000 points' fall in the HSI. The proposal was, however, rejected by the Government as it believed that the FGC should be recapitalised by its shareholders and that the holders of short positions should reach a voluntary agreement not to dump stocks.

Later that afternoon (21 October 1987), the Chairman of the HKFE pressed the Government to agree to a ring out of outstanding HSI contracts on the basis of the last trading price at the close of the market on 19 October to prevent a collapse of the Exchange. This was again resisted by Government.

Following meetings between the Financial Secretary and the various parties involved on the HKFE and having regard to the different views and the complexity of the issues involved, the Government on 22 October 1987 engaged Hambros Bank Ltd., a leading London merchant bank, to act as Government's adviser on the matter. The Hambros' team was led by the Deputy Chairman of the Bank and included the Chairman of the London International Financial Futures Exchange (LIFFE).

After a series of meetings with the various participants in the market and a detailed analysis of the options available to the Government, a support package was put together over the weekend of 24/25 October 1987. The package consisted of a \$2 billion loan, attracting market-related interest rates, to the FGC. This comprised \$0.5 billion from the FGC's seven shareholders (*viz.* ICCH, Chartered Capital Corporation Ltd., Credit Lyonnais interests, Chase Manhattan

Overseas Banking Corporation Ltd., Barclays Bank PLC, Wing On Bank and Hongkong and Shanghai Bank); \$0.5 billion from a number of brokers and members of the HKFE; and \$1 billion from the Hong Kong Government's Exchange Fund. Repayment would be through a transaction levy on the HKFE, a special levy on the SEHK and from delayed payments by and recoveries from defaulting members.

Other elements of the package included a reorganisation of the top management of the HKFE (under which Mr. Wilfrid Newton and Mr. Phillip Thorpe were appointed Chairman and Executive Vice-chairman of the Exchange) and undertakings from arbitrageurs not to sell any stocks held against short futures contracts until 31 December 1987 (the expiry of the longest Hang Seng Index contract then in existence) unless they closed out an equivalent short position on the futures market. They also undertook not to sell any securities matched against November HSI contracts until 1 November 1987 (the day when the November contract became the spot contract).⁶

Both the stock and futures markets reopened at 11:00 a.m. on 26 October 1987. The stock market opened sharply lower and the HSI plunged 1,120 points to close at 2,242, a 33% fall. On the HSI futures markets, a temporary ruling was imposed banning all selling except for liquidation, and the deposit on the contract was raised from \$10,000 to \$25,000 per contract. Spot month trading plunged to 1,975 in after hours trading, a drop of 1,544 or 44% on the spot month.

In the light of the record fall during the day and since many futures brokers with long positions were unlikely to be able to put up further margins, the Chairman of the FGC advised the Financial Secretary in the afternoon that, unless additional resources could be provided, the FGC would have no option but to cease writing guarantee, leading to the closure of the HKFE.

To enable the FGC to meet its obligations, arrangements were made that evening to provide an additional \$2 billion support facility⁷, comprising \$1 billion from the Exchange Fund, and \$1 billion from

⁶ Subsequent returns provided by the arbitrageurs showed that these undertakings were honoured.

⁷ This facility expired on 26 April 1988 without having been drawn down.

the Hongkong and Shanghai Bank, the Standard Chartered Bank and the Bank of China in equal parts. This further facility would have enabled the FGC to continue to operate even if the HSI had dropped to the 1,000 level.

Moreover, in response to a request from a number of listed companies, the Takeovers Committee announced on 26 October 1987 a one-month waiver of the trigger and creeper provisions of Rule 33 of the Hong Kong Code on Takeovers and Mergers, provided there was full disclosure and that the positions were unwound within 12 months.

Furthermore, in an effort to support the market, the banks in Hong Kong made two successive 1% cuts in the prime rate from 8.5% to 7.5% on 26 October and then to 6.5% on 27 October 1987.

On 28 October 1987, the SEHK announced the appointment of Mr. Robert Fell as the Senior Chief Executive of the Exchange.

After discounting margin payments made by futures brokers and liquidation by the clearing house of some 27,000 net long positions out of an overall uncovered position of 37,000 plus contracts, a total of \$1.795 billion was drawn down from the support facility to enable the FGC to meet its obligations.

On 16 November 1987, the Governor appointed the Securities Review Committee to review the constitution, management and operations of the two Exchanges and their regulators.

On 2 January 1988 Mr. Ronald Li, who had by then retired as Chairman of the SEHK but continued as a member of the Committee, was arrested by officers of the Independent Commission Against Corruption (ICAC) and charged, on 15 January, under the Prevention of Bribery Ordinance with unlawfully accepting an advantage, namely a beneficial interest in an allotment of shares in a construction company in relation to the approval of a new issue of shares. Mr. Li and six other members of the Committee, who had not been charged, agreed to distance themselves from the affairs of the Exchange. Thereafter the management of the Exchange was vested in a 14-member Management Committee.

Recommendations of the Davison Report⁸

Background

On 19 October 1987, following a week of set-backs on Wall Street, the world's securities markets braced themselves for a storm. As the markets opened, news of sharp declines spread around the world, culminating in a further 22.6% drop on Wall Street, the sharpest decline it had ever experienced, surpassing even the worst traumas of the 1929 crash. Other markets followed suit, with London, Tokyo, Australia, Singapore and the other Asian markets showing record declines over the next few days.

Hong Kong was not immune, falling 11.1% on 19 October alone, but its experience of the October crash was nevertheless unique⁹: on 20 October, the stock market closed for the rest of the week; the stock index futures market did the same. Massive defaults by futures brokers followed and a \$2 billion¹⁰ rescue package was assembled by the Government in conjunction with major brokers and banks to save the Hong Kong Futures Guarantee Corporation and the futures market from bankruptcy and to protect the rest of Hong Kong's financial system. When the Exchanges re-opened on 26 October, the market plunged a massive 33% and a further \$2 billion rescue package had to be put together overnight by the Government, the Hongkong and Shanghai Bank, Standard Chartered Bank and the Bank of China.¹¹

Prior to October, the Hong Kong stock market, along with other world equity markets, had been on a strong uptrend for some time. The index had risen by 1,410 points or 55% to an all-time high of 3,950 over the nine months to 1 October, with turnover almost trebling.

⁸ Extracted from Overview (Chapter I) of the Davison Report.

⁹ The events of October 1987 are discussed in detail in the section on *The Closure of the Stock Exchange of Hong Kong*.

¹⁰ US\$256 million. When dollars are used in this report, they are, unless otherwise stated, Hong Kong dollars. At the time of drafting, rates of exchange were HK\$7.8=US\$1; and HK\$14.5=UK£1. These rates have been used, wherever appropriate, in this report.

¹¹ In the event this second \$2 billion was not needed.

From its inception in May 1986, turnover at the stock index futures market had grown at an extraordinary pace. In September 1987, 601,005 lots were being traded, an almost twenty fold increase over 17 months, so that its protagonists could claim that it was the second largest index futures market in the world.¹² Unfortunately, neither the market infrastructure nor the regulatory systems kept pace.

It was against this background that we were appointed by the Governor on 16 November 1987¹³ to review the constitution, management and operation of the two Exchanges and their regulatory bodies. We were directed to examine structures and systems critically rather than to allocate blame or conduct an inquiry into the causes and events of the crash.

Major criticisms

We found that, while the entire system had originally been based on self-regulation by the Exchanges with "the support of an authoritative and impartial body to assist them in taking action themselves to curb questionable practices"¹⁴, the concept of self-regulation and market self-discipline had failed to develop in Hong Kong. What is equally unfortunate is that, faced with this, the supervisory bodies charged with overseeing the markets had lost effective control.

While our terms of reference required us to prepare a blue-print for the future rather than to allocate blame, it proved to be inevitable that our review would highlight defects in the past arrangements. These defects came to our attention through submissions we received and discussions we held. We did not consider it part of our role to

¹² Measured in numbers of contracts traded; it was relatively much smaller in terms of the value of open positions. See fourth paragraph in the section on *Objectives and Principles*.

¹³ Members of the Securities Review Committee: Ian Hay Davison, S.L. CHEN, CBE, JP, LAU Wah-sum, JP, The Honourable Peter POON Wing-Cheung, MBE, JP, Charles SOO and Philip TOSE.

¹⁴ Statement by the then Financial Secretary, Sir Philip Haddon-Cave, in the Legislative Council on 3 January 1973, announcing the establishment of the Securities Advisory Council, the fore-runner of the Securities Commission.

investigate in any detail but they were sufficient for us to form the view that major reforms were called for. In our view, they may be summarised as follows:

- (a) at the Stock Exchange of Hong Kong, which had opened in April 1986 after the unification of four smaller exchanges, an inside group treated the Exchange as a private club rather than a public utility for the general benefit of members, investors and issuers. Its executive staff was ineffective, lacking adequate knowledge and experience to cope with the evolving and expanding securities industry, and insufficiently independent of the governing Committee. The settlement system, based on a 24-hour cycle, had failed to function properly and indeed could not have been expected to do so in the face of the increasing volumes and internationalisation of the market. There were serious shortcomings in the listing arrangements, and surveillance of members was cursory. Thus, while the governing Committee had been successful in developing the business of the Exchange, they had not introduced proper management and regulatory arrangements and, in particular, had failed to take into account the risks in an overheated system;
- (b) at the revamped Hong Kong Futures Exchange¹⁵, the management was somewhat better but was built on shaky foundations. In particular, the tripartite structure of Exchange, Clearing House and Guarantee Corporation confused lines of responsibility and effectively obstructed the development of an adequate risk management system, which is essential to any futures market. All three agencies should have acted to contain the dangers in the expansion of business and the build up of large positions by a few investors;
- (c) at the Securities Commission and the Commodities Trading Commission, which had been set up as overlords of the industry, there was a general absence of direction. The Government's

¹⁵ It was relicensed in 1984 after an earlier crisis and subsequently reorganised.

original intention that they should be independent and authoritative, had not been carried out. Rather than being high-powered watchdogs, they had been relegated in recent years to a passive and reactive role; and

- (d) at the Office of the Commissioner for Securities and Commodities Trading established within the Administration to service the Commissions, the Commissioner's repeated pleas for additional resources to cope with the rapidly developing markets had often been delayed or rejected by Government. But the allocation of what little resources were available reflected too much emphasis on vetting papers rather than on active surveillance and monitoring of markets and brokers. Moreover, faced recently with a determined and forceful Stock Exchange leadership, and lacking sufficient support from Government, it had lost the initiative.

Main recommendations

We believe that Hong Kong should aim to be the primary capital market for the South East Asian region and to that end should encourage the development of new markets and the international element of existing ones by strengthening its systems and regulatory arrangements. We reject fundamental changes in favour of building on existing systems, as the success of Hong Kong's financial services market depends largely on the healthy working of the free enterprise system which has demonstrated a dynamic capacity for promoting innovation and growth. We have therefore decided that practitioner regulation should continue but that safeguards will have to be introduced at every level.

To this end, we have recommended, inter alia:

- (a) a fundamental revision of the internal constitution of both the Exchanges; in particular, in the case of the Stock Exchange, there should be proper representation on the governing body

- for individual and corporate members, combined with an independent element to ensure that the Exchange is properly governed and works in the interests of all members and users;
- (b) the development of a staff of professional, independent executives in the two Exchanges, with the Exchange governing bodies setting policy and the executives implementing it;
 - (c) an extension of the Stock Exchange settlement period to three days which should be strictly enforced and the early development of a central clearing system;
 - (d) the continuation of the Hong Kong Futures Exchange and its stock index contract but with the clearing and guarantee system being restructured to strengthen the risk management arrangements; in particular, the clearing house should become part of the Exchange and the guarantee should be backed by a Clearing Members' Fund; and
 - (e) replacing the two Commissions and the Commissioner's Office with a single independent statutory body outside the Civil Service; it should be headed and staffed by full-time regulators and funded largely by the market; it should be charged with ensuring the integrity of markets and the protection of investors; in particular, it should ensure that the Exchanges properly regulate their markets and should have extensive reserve powers to intervene if they fall down on the job.

We believe that the early implementation of our recommendations will lay the foundations for the proper regulation of the Hong Kong securities industry.

Objectives and Principles¹⁶

Introduction

In this chapter, we describe our objectives and strategy as it is important that the principles which have guided the formulation of our recommendations should be clearly stated. We hope that this will allow our proposals to be looked at in their proper context.

Our starting point is that the approach taken to the management and regulation of Hong Kong's securities markets must depend on the overall objectives for the industry. If Hong Kong is content with a largely domestic market, the main thrust should be to ensure systemic stability together with an appropriate element of protection for investors. However, if Hong Kong harbours ambitions to be a regional or international market, it is necessary to go further by ensuring that its systems cater for overseas investors and intermediaries, that its regulatory regime broadly satisfies prevailing international standards and that its markets develop in scope and depth. We begin, therefore, by examining Hong Kong's position in world financial markets and identifying what we believe to be a challenging but realisable set of objectives.

Hong Kong's financial markets

In accordance with our terms of reference, this report concentrates on the stock and futures markets. The Stock Exchange of Hong Kong Limited (SEHK) has 276 listed companies, virtually all of which are locally incorporated. Its total market capitalisation was \$420 billion (US\$54 billion) at end 1987, accounting for 0.67% of the total

¹⁶ Extracted from *Objectives and Principles* (Chapter III) of the Davison Report.

capitalisation of all FIBV exchanges.¹⁷ It ranks 20th among all FIBV exchanges but is third after the two Japanese exchanges in Asia.¹⁸ The Hong Kong stock market is characterised by a particularly vigorous retail element.

The Hong Kong Futures Exchange Limited (HKFE) operates four futures contracts: sugar, soyabeans, gold and the Hang Seng Index. The sugar and soyabean markets are largely spin-offs from the Japanese market, with monthly averages of 20,000 and 30,000 contracts respectively. The gold market is essentially a price-fixing mechanism and averages around 500 contracts monthly. The Hang Seng Index contract grew rapidly from its launch in May 1986 reaching a peak of some 600,000 contracts traded in the month of September 1987¹⁹ but since the crash turnover has declined, with only 30-40,000 contracts currently being traded each month.

While both the SEHK and the HKFE attract international interest, they do so mainly as "fringe" markets. Four main reasons are advanced for this:

- (a) the market is small in terms of capitalisation. The main international investors tend to spread their portfolios on the basis of the relative capitalisation of the world's major markets; Hong Kong, accounting for less than 1%, would theoretically account for no more than 1% of their portfolios - although in practice it has in the past accounted for much more in some cases;

¹⁷ The FIBV (Federation Internationale des Bourses de Valeurs) is an international federation of stock exchanges established in 1961. As at end 1987, it covers 33 exchanges (or national associations of stock exchanges) in 28 countries, comprising the world's major equity markets.

¹⁸ See Appendix 8 of the Davison Report for a comparison of the Stock Exchange of Hong Kong with other stock exchanges.

¹⁹ The turnover of the following stock index futures contracts valued at the month end cash index for September 1987 was as follows:

<u>Index Contract</u>	<u>Exchange</u>	<u>\$US billion</u>
Hang Seng	HKFE	15.2
Standard & Poor 500	CME	312.0
NYSE Composite	NYFE	30.4
FT-SE 100	LIFFE	4.8

- (b) it has a narrow range of listed companies and there is a lack of liquidity in the second and third line stocks. Hence, only a minority satisfy the liquidity needs of institutional investors²⁰;
- (c) its settlement system is antiquated and inadequate and acts as an impediment to foreign institutional investors entering the market; and
- (d) it is not well-regulated, which we understand may discourage some of the larger endowment and pension funds from investing in it.

Hong Kong has a considerable range of other financial markets however, including:

- (a) **the foreign exchange market.** All the major international currencies - US dollar, Deutschmark, Yen, Sterling and Swiss Franc - are actively traded between banks, deposit-taking companies and large corporations. Trade with other foreign exchange markets in other financial centres is very active, especially Tokyo and Singapore and the overnight market with Europe and the US. While there are no statistics on market turnover, it is believed to be sizeable - industry estimates put it at US\$25-35 billion daily;
- (b) **the inter-bank market.** Basically a wholesale market, with minimum transactions of \$1 million, used by banks and deposit-taking companies for short-term money (from overnight up to six months for Hong Kong dollars and up to 12 months for US dollars). Total inter-bank (including deposit-taking companies) Hong Kong dollar liabilities at end December 1987 were \$200 billion (US\$26 billion), while total inter-bank foreign currency

²⁰ In a recent survey undertaken by the Hong Kong Unit Trust Association, only \$3.9 billion (US\$500 million) or just over 5% of their members' assets, were invested in Hong Kong.

- liabilities on the same date amounted to \$2,087 billion (US\$268 billion). The latter market is crucial to the banking sector because, in the absence of Government debt, much of the sector's primary liquid assets are denominated in foreign currencies.²¹ The inter-bank market is dominated by the Hongkong and Shanghai Bank;
- (c) **the debt market.** As Hong Kong is essentially a balanced-budget economy, there is no Government borrowing programme.²² Neither is there a medium or long term corporate debt market. The two main types of debt instruments are certificates of deposit (CDs) and commercial paper (CP). CDs (short and medium term) are issued by banks and deposit-taking companies while CP (short term) is issued by top quality Hong Kong corporations, and are largely held by banks. The value of CP and CD issues authorised during 1987 was \$36.5 billion (US\$4.7 billion); and
- (d) **the gold market.** In terms of trading volume, the local gold market is one of the largest in the world, ranking alongside London and Zurich. Trading is done mainly on the Chinese Gold and Silver Exchange and in the loco-London market. Total turnover on the Chinese Gold and Silver Exchange amounted to \$292 billion (US\$37.4 billion) during 1987.²³

Detailed statistics on trading in the loco-London market are not available but the volume is understood to be significant.

²¹ As at end 1987, about 81% of the banking sector's aggregate liabilities or assets were denominated in foreign currencies.

²² The only Government debt instrument outstanding is the \$1 billion (US\$128 million) negotiable five-year bond issued in April 1984.

²³ Using the end of year price of US\$486 per troy ounce.

Hong Kong is also a major centre for overseas Chinese wishing to divest funds from their home base in the region. In recent years, it has re-emerged as the principal entrepot for China²⁴ and has become an important base for China-related investment.

Because of the activity in all these areas, a large range of financial institutions are present in Hong Kong as the following figures show:

at 31st Dec 1987	
Banks ²⁵	155
Deposit-taking companies ²⁵	267
Fund management companies (managing 504 unit trusts/mutual funds)	99
Registered members of the Stock Exchange of Hong Kong	735
Registered dealers in commodities	325
Authorised insurers	278

In summary, Hong Kong is neither a closed domestic market nor a fully-fledged international capital market in the Tokyo, New York or London mould. It can best be described as an important financial base for South East Asia with an extraordinarily rich mix of local and international players and a vigorous local retail element. However, while it is a first class regional centre for commercial and financial activities, notably international banking, its securities market does not currently measure up to its other economic achievements.

²⁴ During the past decade, Hong Kong has witnessed a rapid re-emergence of its entrepot role. Re-exports now represent roughly 50% of total exports. In 1987, China was the market for about 33% of Hong Kong's exports and the source for about 46% of its re-exports.

²⁵ Of which 273 were incorporated overseas or had overseas parents. Together these represent approximately 30 countries. Hong Kong ranks third, after London and New York, in numbers of banks represented.

We were nevertheless told by a number of international investment houses that they foresaw a rapid expansion of the securities industry in South East Asia, with Hong Kong becoming the pre-eminent regional centre.

Strategic objectives

It has been argued that since Hong Kong is primarily a services centre (as opposed to a major capital market), essentially inward-looking domestic stock and futures markets would not detract from its strengths as a banking and fund management base. This seems to us to ignore the fact that Hong Kong's remarkable success is in large part due to the openness of its economy and we do not see a case for making an exception of capital markets. Moreover, we take the view that a healthy securities market is an essential ingredient of any financial centre of standing. It attracts the full range of financial institutions, expertise and services which augment Hong Kong's financial infrastructure and, directly or indirectly, can add to the funds available to finance investment. It might also be important to Hong Kong's role *vis-à-vis* China as it could fill a gap in China's financial infrastructure.

While acknowledging the potential benefits, some would stress the risks and potential costs of internationalisation. The recent crash illustrates the point that, notwithstanding good fundamentals for the domestic economy and companies, Hong Kong markets can plummet in sympathy with falls elsewhere. Moreover, anecdotal evidence suggests that overseas investors were amongst the largest sellers in October. We accept that becoming a corner of the so-called "global marketplace" carries risks, but we believe October demonstrates that these probably cannot now be avoided in any case. Hong Kong must act to capitalise on the international interest in its market while minimising the risks by strengthening its systems and controls. We believe, therefore, that Hong Kong should aim to become the pre-eminent capital market in South East Asia and to that end, should see the progressive internationalisation of its securities markets as an

important strategic objective; by internationalisation we mean the use of Hong Kong's markets by issuers, investors and intermediaries from outside the territory.

Hong Kong's chances of achieving this goal will depend on its strengths and whether it can overcome some of its man-made weaknesses. Its main **strengths** as a financial market are:

- (a) excellent economic performance;
- (b) excellent communications - convenient airport; good telecommunications;
- (c) a convenient time zone - equidistant between London and San Francisco, one hour from Tokyo, open while New York is closed;
- (d) an abundance of liquidity - it is traditionally a haven for overseas Chinese money;
- (e) a large pool of talented, hardworking middle management and entrepreneurial ability;
- (f) language capabilities;
- (g) the availability of professional infrastructure;
- (h) relatively low costs compared with other major international financial centres;
- (i) a free economy: no exchange controls; low and stable income and corporate tax rates; freedom of movement and free press; and
- (j) the major gateway to China.

Its main **weaknesses** as a securities market are:

- (a) a small economy with a relatively small pool of domestic savings available for investment and few companies suitable for listing;
- (b) a narrow range of businesses represented on the SEHK - preponderantly property and finance companies, few foreign companies listed;
- (c) a limited number of indigenous corporations trading on a significant scale outside Hong Kong;

- (d) the absence of a full range of traded financial products;
- (e) inadequate supervision and regulation of the securities industry compared with leading financial centres which have developed fair and orderly markets;
- (f) the lack of a consistent/coherent Government policy to promote and underpin Hong Kong's financial services industry; and
- (g) political uncertainties and brain drain as Chinese middle management leave.

There is also the damage to international confidence inflicted by events during and after the October crash. The Hong Kong authorities and Exchanges need to take steps to assure the world that there will not be a recurrence of the market closure and the futures market collapse.²⁶

On balance, we believe the strengths can outweigh the weaknesses provided that positive and determined action is taken to overcome the obstacles. As we see it, therefore, the main tasks before us have been to assist in restoring confidence by putting in train changes which will improve the operation and regulation of the two Exchanges; and to make proposals as to how the conditions might be created for broadening and deepening the markets.

Market requirements

If these were to be more than pious hopes, we had to be clear about the basic conditions necessary for the market to flourish. We concluded first that markets must be free to develop. Secondly that investors, issuers and intermediaries, both local and overseas, must be confident

²⁶ In a survey of international investors' attitudes towards the market closure conducted in London, New York, Tokyo, Sydney and Hong Kong in December 1987 by Burson-Marsteller on behalf of the Stock Exchange of Hong Kong Ltd., respondents were unanimously of the view that the closure had adversely affected the Exchange's international reputation and had eroded confidence in the Hong Kong market, at least in the short term. See Appendix 9 of the Davison Report for the key findings of this survey.

that Hong Kong's securities markets are efficient and effective in the sense that they are liquid, that transaction costs are low and that prices accurately reflect the totality of supply and demand, adjusting quickly to all information relevant to prospective returns and risks.

As to the development of markets, we believe that financial markets should be as free from constraints as is consistent with their integrity and the protection of investors. In particular, new markets should be permitted provided appropriate safeguards are in place. Similarly, barriers to entry should be set at levels which keep out the "fly by nights" while not deterring bona-fide firms. Furthermore, business should not be impeded by regulations designed to maintain structural or institutional features for their own sake. We therefore believe, for example, that tax neutrality between market segments is a laudable objective. It will be important to consider ways and means of enhancing the Hong Kong securities markets and to develop a broad strategy for their future development. This will involve a considered and concerted effort by the securities industry and the Government to eliminate possible impediments.

As to confidence in the efficiency of markets, we believe that, for this to be secured, it is important that the market environment should satisfy the following tests:

- (a) **systemic stability.** The market should not be threatened by major market breakdowns, but if they do occur contingency measures should be available. Systemic stability is a particularly important objective in Hong Kong where the closure of the stock market and the collapse of the futures exchange struck right at the heart of the system. The need for systemic stability raises questions about the management of risk and capital adequacy;
- (b) **orderly and smooth functioning market.** The marketplace should function efficiently and smoothly. Its operations should be regular and reliable. There should be price continuity in depth. Large and unreasonable price variations should not occur

- between consecutive sales; nor should sharp price movements occur without appropriate accompanying volumes. Dealing, settlement and price notification procedures should work smoothly without breaks or delays. This objective raises questions about mechanisms and relationships surrounding the market. Systems and procedures lie at the heart of the problem;
- (c) **fair market.** The market should be free from manipulation and deception so that no unfair advantage accrues to any participant; and shareholders in a public company should be treated equally. This raises questions about price transparency and disclosure. Companies should promptly provide adequate information to enable investors to make informed decisions, bearing in mind the availability of securities analysts who should detect misleading statements and help to ensure that company data translates itself into appropriate price adjustments; and
 - (d) **protection of investors.** The doctrine of caveat emptor must remain important but should not be given free reign. The private investor must be protected against crooks and fools. This raises questions about entry standards for intermediaries (i.e. honesty and competence), self-discipline, surveillance and enforcement.

The management of risk

Before we move on, however, we feel that, in the light of the events of last October, we should sound a note of caution. We believe that it is wholly inappropriate to attempt to build a system with no fails. Markets will continue to gyrate, sometimes wildly, players will continue to fail and clients will continue to default. No free market system can, or indeed should attempt to, prevent such events from occurring. The important thing is to ensure that problems are localised and do not strike at the heart of the system, bringing about or threatening total or near total collapse of the market. The events of October illustrated the paramount importance of ensuring, as far as possible, that securities market crises do not spill over into other fields such as banking and

money markets. It is therefore imperative that the risks inherent in the market are understood, properly spread and adequately managed.

When everything else is stripped away, the most pressing issue is the management of risk. The focus of this is the Exchanges and, increasingly, the central clearing houses - indeed the prudent operation of central clearing houses is perhaps the single most important objective for the market authorities and regulators. Awareness of this seems to have been lacking in Hong Kong, both in the market and in the regulatory bodies.

Regulation

In summary, then, we would set Hong Kong the following objectives: financial markets should be stable, orderly, fair and offer adequate protection to investors at reasonable cost. To achieve these objectives standards must be set and monitored.

The question is whether this should be done by the industry or by Government. The Companies Law Revision Committee, in its 1971 Report on the Protection of Investors, were "... convinced that the Government should not get deeply involved in attempts to regulate and supervise stock exchanges and dealings thereon..." We support the concept of market regulation and agree that the Hong Kong Government, in line with its traditional free market philosophy, should see its role as providing the necessary environment and framework in which markets can develop and flourish.

Self-regulation

We appreciate that so-called self-regulation may appear to have failed in Hong Kong. Nevertheless, we continue to recommend a practitioner-based system as the best available to meet our objectives for Hong Kong. We do so because we wish above all to avoid the danger of straight-jacketing the securities markets by a strict statutory regime which might all too easily lead to insensitive or heavy handed over-

regulation. Laissez-faire has served Hong Kong too well for it to be abandoned altogether just because it has been ineptly used and grossly abused.

Market management and regulation by practitioners offers scope for flexibility and adaptability in a rapidly changing market. Moreover, it draws on the market knowledge of practitioners and thereby is better able to win the support of market members. Statutory processes, because they have full legal force, are necessarily slow; and statutory regulators will not always have the necessary knowledge and experience.

There is a further reason, however. Given the complexity of modern securities markets and the speed of market events, we believe that there is no alternative to practitioner-based regulation. Only the market authorities can keep abreast of overall market conditions and the financial position of intermediaries; and are in a position to undertake on the spot detection of trading abuses. The objective should, therefore, be to get as near to on-line supervision as possible; the Exchanges and the clearing houses can approach this as part of their routine daily operations.

Finally, we think it appropriate to recognise that since October 1987, both the Stock Exchange and the Futures Exchange in Hong Kong have taken substantial steps to put their houses in order. We wish to support those moves.

As an extension of this, in addition to seeing the Exchanges continuing to have a very material place as self-regulators, we encourage the development of a role for other market and industry user organisations. For example, we hope that market practitioners will take the lead in developing codes of practice. We prefer codes to statutes. They are easier to draft and to follow. They may lack statutory force but breach of a code can provide grounds for statutory action.

Checks and balances

However, there must be an important proviso: that effective arrangements are made to safeguard the system against insider regulation. As observed by the US General Accounting Office in a report on the SEC,

"Although conceptually self-regulation entails benefits such as foregoing excessive government involvement, it also carries potential risks. One danger is that self-regulators ... may be less diligent than might be desired because they are regulating their own industry. Another theoretical risk is that [industry bodies] will use self-regulatory powers to impair competition in order to satisfy private interests rather than self-regulatory needs."²⁷

Neither of these risks is theoretical in Hong Kong. Indeed, the following statement made in 1983 by the Chairman of a US House of Representatives Committee is particularly pertinent,

"[the] worst setback to industry self-regulation would be a scandal resulting from either inaction of the SRO's to adequately police their members or ineffective oversight of the SRO's by the Commission."²⁸

Recent events in Hong Kong have in our view demonstrated beyond doubt that checks and balances are imperative at every level of the system. This fundamental principle underlies the structure we propose.

²⁷ United States General Accounting Office, "Securities and Exchange Commission: Oversight of Self Regulation", September 1986.

²⁸ From a letter to the SEC by the Chairman of the House of Representatives Subcommittee on Telecommunications, Consumer Protection and Finance of the Committee on Energy and Commerce. "SRO" means "self-regulatory organisation".

First, we believe it is essential to have a two-tier system of supervision with exchange regulation of its own affairs being conducted under the watchful eye of a single statutory body. The statutory supervisor is thus the watch-dog, with the market handling the day-to-day supervision and regulatory tasks.

Second, we advocate the detachment of the statutory supervisor from Government. If the supervisor fails then, and only then, should the Government step in; Government should be insulated from day-to-day market crises lest the authority of Government be unnecessarily damaged.

Third, the integrity of the market organisations must be - and be seen to be - undoubted and the governing bodies of such organisations should represent all the interests involved to ensure that policy decisions reflect the needs of the market as a whole. We also propose the inclusion of independent members on the boards of the market agencies - the exchanges and the clearing houses. This independent element will, we trust, provide a check on the market members lest insider interests intrude into the regulatory process and also act to remind the exchanges that securities markets exist to serve capital raisers, investors and the public generally, as well as the interests of securities dealers and advisers. The independent members will have relevant expertise in the industry but will not be members of the exchanges or clearing houses.

But the first line of defence must be provided by detached independent well-paid and qualified exchange staff who can apply the rules to the market impartially and with neither fear nor favour. The development of such a cadre of professionals, while a significant challenge, is an essential element of our plan. Market members have a large part to play in the development of policies for market regulation; because of conflicts of interest they should have little part to play in applying those rules.

Costs

While we believe therefore that an element of statutory regulation is necessary, we would warn that regulatory controls can all too easily reach a state where they hamper rather than facilitate an efficient securities market. This can happen in two senses: competition may be impaired; and regulation may impose costs which add to the overheads of intermediaries and hence to transaction costs. Regulators must therefore be vigilant to see that a proper balance is kept between the benefits of regulation and its costs.

A Hong Kong solution

Finally, as we have already explained, Hong Kong is a unique, and in many senses, unusual securities market. The regulatory regime must be appropriate to its current and expected future circumstances.

First of all, we have adopted a policy of "horses for courses". Within the general framework described above, we have tried to avoid a monolithic solution, with the same pattern recurring in each segment of the marketplace. Thus, in some instances, we envisage the statutory body having direct supervisory responsibility, as there is no available market association to take on the job and the current arrangements seem to work reasonably well.

Second, we have paid due regard to the relative lack of regulatory resources and experience in Hong Kong.

Third, we have borne in mind the strong local retail element in Hong Kong's markets and that, in contrast to many centres, the small investor is not especially risk averse.

Fourth, and most critically, we have sought to develop policies which will strengthen the position of local brokers, dealers and advisers in a rapidly changing market.

This then is the strategy we propose for Hong Kong securities markets.