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18 Hong Kong and Global Markets: Back to Basics

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I am very honoured to be invited by the Hong Kong General Chamber of Commerce to deliver my maiden speech as the new Chairman of the Securities and Futures Commission. After less than one month on the job, I cannot say that I have learnt enough to give profound views about the securities markets in Hong Kong.

What I propose to do this afternoon is to pose you the questions that I asked myself when I agreed to lead the SFC. The three questions are:

- First, what is the appropriate regulatory and governance structure for the securities industry in Hong Kong?
- Second, what is the right role of Hong Kong as the premier international financial centre for China? And
- Third, what is the correct positioning of Hong Kong within the context of rapid changes in regional and global financial markets?

These are enormously difficult questions, and there are no simple answers. But I hope that in the days to come, after consultations with my colleagues, members of the financial community, and with your help, I will find the right approach. By next year, when the SFC will celebrate its Tenth Anniversary, its mission for the next decade would become that much clearer.

I would like to take this opportunity to pay tribute to a few persons who have helped me tremendously in preparing for this job.

First, Mr Joseph Yam, my former boss at the Hong Kong Monetary Authority, who taught me all about the financial markets in Hong Kong. Second, Mr Anthony Neoh, my distinguished predecessor as Chairman, who led Hong Kong into the leading ranks of securities regulators internationally, and whose first advice to me was to "keep calm". Third, two eminent and former Chairmen of the Hong Kong Stock Exchange, Dr QW Lee and Dr Edgar Cheng, who gave me profoundly wise insights and advice on the questions that I have posed myself. Needless to say, I cannot acknowledge enough the advice of all whom I have consulted on these issues.

Lessons from the Asian crisis

To begin with, allow me to place the three questions within a broader perspective of what we can learn from the past and what we believe could be a vision of the future. Specifically:

- What can we learn from the Asian crisis?
- What is the paradigm for securities markets in the 21st century?

In hindsight, the traumatic 1987 stock market crash that gave rise to the creation of the Securities and Futures Commission was a blip in the bull market of the 1990s. The distinguishing feature of the recent Asian crisis was its complexity. No one foresaw its ferocity and speed of contagion. In little more than one year, 40% of the world economy moved from a boom to either recession or deflation. We moved from Alan Greenspan's phase of undue exuberance in expected returns and undue lack of diligence in risk assessment to undue pessimism within a matter of months.

Make no mistake. Everyone is in shock: from investors, workers, corporations, financial institutions, academics, regulators and policy makers alike. The days of easy money are over. We need to get back to basics. But what are the basics? These are the five C's of **credit, capital, competition, confidence** and **co-operation**.

As co-chair of the G22 Working Group on Transparency and Accountability, I had the privilege of reflecting on these basic issues. Clearly, one major reason why Asia got into trouble was too much **credit** chasing too few good assets, leading to over-leveraging and bubbles. Many Asian corporations enjoyed easy credit and under-estimated the rise in global **competition**, leading to a new phase of contraction and consolidation. **Confidence** in counterparty risks and even the integrity of markets has been shaken as capital rapidly fled from fragile markets.

We are now in the de-leveraging phase. But corporations can only de-leverage through more **capital** and less debt. Hence, the value of capital and securities markets. This brings home the basic truth: *the main function of securities markets is to raise capital.*

As an international financial centre with high costs, Hong Kong has to recognize that its capital-raising capability is facing many challenges and severe competition: functionally and geographically. To put it simply, markets are drifting to those centres that are most transparent, liquid, efficient, competitive, fair and robust in terms of financial infrastructure and regulation.

As market participants, all of you know that you have to lower costs, increase productivity and move up the quality curve in terms of product and service in order to compete. As a market regulator, *I have to recognize that Hong Kong is also facing severe regulatory competition*. Singapore Senior Minister Lee Kuan Yew paid Hong Kong the highest tribute when he said that we were regulated "with a light touch". He could have added "firm and fair".

British Prime Minister Tony Blair was spot-on when he said in Hong Kong earlier this month that the global crisis is so complex that no single person, corporation or economy can solve it alone. This is where the last C: **co-operation**, comes in. Amidst fierce domestic and international competition, we must somehow work together to reform, consolidate and build for the recovery.

As I said to Chairman HC Lee during the 12th Anniversary celebrations of the Stock Exchange ten days ago, the SFC and the

Stock Exchange would have to work together to ensure that our markets are vibrant, healthy, transparent and fair. The development of markets and new business is the focus of the Stock and Futures Exchanges. The SFC's mission, as regulator, is to ensure that the regulatory environment *facilitates* market competition, innovation and growth.

Securities Markets of the 21st Century

Before I get into the role of regulation in the development of financial markets, we need a big picture of where we think we are going. There are several trends that are worthwhile noting.

First, *the markets are moving into global, 24-hour trading*. Witness how over 20% of Hong Kong stocks are now traded in London and increasingly in New York. More and more emerging market stocks will be traded in the main centres on a 24-hour basis.

Second, *it is technology driven*. New technology has transcended time and geography, speeding up transactions, driving down costs and creating new products. Traditional exchanges are losing their franchise, as they find the NASDAQs of this world compete with them on listings, liquidity and intermediation costs. Twenty per cent of orders through NASDAQ are now through the Web.

Third, *fierce competition will come through innovation and change*. Witness how the Frankfurt Deutsche Terminborse (DTB) electronic trading system wiped the floor off the open outcry London International Financial Futures and Options Exchange (LIFFE) market in the Bund futures contract in a matter of months, leading to a strategic alliance between the London and Frankfurt stock exchanges. Similarly, a memorandum of understanding has already been signed between the London Stock Exchange and the Shanghai Stock Exchange.

Consequently, if you were to ask how well the Hong Kong securities market fits into that vision of a global, high-tech, fiercely competitive world, it is quite clear that we have a lot of hard work ahead of us. We have many strengths, which I need not elaborate here, but we should not take our advantages for granted given the fierce challenges.

Making the Markets Work Better

Let me now recap on what I think the problems of the recent past and the trends of the future bring to the present. We can sum up these in a few basic points:

- There are global markets, but unco-ordinated, obsolete local laws and regulations;
- Too much liquidity/credit chasing too small markets make for bubbles and deflation;
- Bad accounts = bad statistics = bad decisions and policies = poor risk management = financial crisis; and
- For globalized markets to work, we need co-ordinated policies, harmonized accounting and legal standards, freer market entry, greater competition and orderly market exit.

What are the implications of these lessons for Hong Kong?

The answers are obvious. As an international financial centre, we are an open market and we must meet international standards of accounting, law, transparency, accountability and business conduct. In short, we must meet the highest international standards in order to make the market work better.

Indeed, to me personally, one of the reasons why the best and brightest of academia and policy makers did not foresee the global crisis was this: we all understood the macro-economics of free markets, but we did not fully comprehend, as Chairman Greenspan acknowledged recently in his testimony to Congress, how the microstructure of free markets really work under the emergence of new technology and innovation.

As Sherlock Holmes wisely observed, the enigma lay in "which dog that did not bark in the night". A free market assumes that there exists a sound framework of accounting standards, laws and regulations, court systems, bankruptcy and anti-trust laws that ensure fair, transparent and efficient exchange of property rights. It assumes transparency of information, accountability and checks and balances against market manipulation and abuse. One hallmark of the present crisis is the fallacy of composition. Many of the assumptions made by investors, entrepreneurs, regulators and policy makers turned out to be false, defective or deficient.

Because markets are all about the protection, transfer and exchange of property rights, we come back to the legal framework. Do we have a legal framework that fits the global nature of markets?

In the securities area, two of the most vibrant markets are making major changes in their legislation. The United Kingdom has just published the Financial Services and Markets Bill (FSMB) at the end of July to replace the Financial Services Act 1986, that is 13 years old. Eleven days ago, after 15 years of debate, the United States has just launched an "aircraft carrier" of legislative reforms to the Securities and Exchange Acts of 1933 and 1934 that would deliver information to investors "in a more timely and technologically friendly manner".

Our Securities Ordinance is essentially 25 years old. Our Securities Composite Bill was over five years in the drafting and remains basically a consolidation of past legislation.

- We have to recognize that while Hong Kong has many advantages as one of the leading common law jurisdictions, our securities law for modern, secure and efficient financial markets has now been made somewhat obsolete in view of major changes abroad.
- We have to recognize that markets will move to those centres where investors or creditors know that their property rights in a technological age are protected and transferred with certainty and predictability.
- We have to recognize that legal and regulatory uncertainties add deadweight costs to our competitiveness and our productivity.

It goes without saying that my first priority is to ensure that the securities regulatory framework will fit and facilitate Hong Kong's continuing status as a modern, efficient and competitive international financial centre. As SEC Chairman Arthur Levitt said a fortnight ago in launching his Securities Act Reform Project: "reform is rarely easy but is often necessary". I shall work with everyone of the financial community, my colleagues in the HKSAR Government, the legislature, academia and our friends abroad, to begin this difficult and enormously important task. In this, I will need all the help and support I can get.

SFC's Mission and Philosophy

Having spelt out at least one of my priorities, I would like to say a few words about the mission statement and philosophy of the Securities and Futures Commission. Our Annual Report spells out five key elements:

Confidence	Promote confidence in the efficiency and fairness of Hong Kong's securities and futures markets;
Development	Support the continued development of Hong Kong's markets, especially their role as a capital formation centre for China;
Balance	Strike an appropriate balance between measures that maintain market integrity, provide protection for investors and encourage market development and innovation;
Fairness	Act firmly and fairly, while being responsible and accessible to market participants and the investing public; and
Consultation	Consult the market on major changes to the regulatory environment, taking full account of Hong Kong's environment while maintaining international standards.

My own philosophy is a bit simpler: public confidence and trust, market integrity and fairness, level playing field in competition, and transparency and disclosure. The IOSCO[1] defines the objectives of securities regulation as:

- The protection of investors;
- Ensuring that markets are fair, efficient and transparent; and
- The reduction of systemic risks.

Our work is not done in isolation. Our primary function is that of a securities market regulator which functions together with the self-regulatory organizations, such as the Stock Exchange of Hong Kong and the Hong Kong Futures Exchange. As financial markets converge, we need to regulate in close consultation with other regulatory bodies in Hong Kong, notably the Hong Kong Monetary Authority, the Insurance Commissioner, the Mandatory Provident Fund Authority, the Commercial Crime Bureau of the Police and other departments and bureaux. In the development of standards, we would have to work closely with the Hong Kong Society of Accountants, the Hong Kong Bar Association and the legal community. On the international front, we work with IOSCO and directly with the leading securities regulators in the major and regional markets.

To put it simply, although we are in the business of regulation, we are essentially a knowledge-based service institution within a highly open and knowledge-based economy. Our ability to function effectively depends on our ability to absorb a huge amount of market and regulatory information, to analyse such information and to make regulatory judgements according to the existing body of law.

As we all know, financial markets today are all about information and technology. In order to regulate markets effectively, we need to know our markets well. Thus, we would need to continuously learn and adapt with the markets in order to facilitate market growth and ensure that there are sufficient rules and disincentives to deter market manipulation and abuses.

[1] International Organization of Securities Commissions, "Objectives and Principles of Securities Regulation", September 1998

We also have to be realistic. With complex markets moving faster than regulators and investors can digest, no regulatory system can prevent totally the crises and failures that we continually witness. Excessive regulation can stifle market innovation and growth. Inadequate oversight can lead to large losses due to market abuses. Increasingly, as Andrew Large, the former Chairman of the UK Securities & Investment Board put it: "the only way forward will be for both customers, and the financial industry to take the requisite care to look after their own and their shareholders' interests".

Regulators are therefore also in the information business. We need to ensure that market participants provide accurate, reliable, timely and consistent information for sound investment and risk management decisions to be made. We need to ensure that consolidated information is available to avoid the fallacies of composition that are inherent in markets. Regulators also have to explain clearly to the market what policies and rules to expect and to follow. We need to ensure that investors understand the risks that they are entering into and are well informed of their rights and obligations. Transparency improves economic efficiency and also reinforces accountability.

Since technology has vastly increased the variety of products and services, as well as their risks, regulators must also learn to understand and adopt technology to their advantage. Financial markets cannot move towards real-time transactions if regulatory reporting and tax collection are still paper-based. Complex and highly leveraged derivatives are accidents waiting to happen if the sellers, the buyers, their senior management and their regulators do not understand fully the risks associated with such products.

As I told my colleagues last week, over the next few years, the Commission will have to invest significantly in its people and technology in order to deliver the highest quality of regulatory service you would expect from a vibrant, efficient and open international financial centre. We will do this through a careful harnessing of our budget, which is subject to the approval of the Government and ratification by the legislative process, towards value for money. If we regulate markets, we have to behave in a more market responsive manner.

In the next few years, I envisage that the SFC will be an open, adaptive institution, with a mission to achieve the highest international standards of regulation that are light, firm and fair. If we expect the market to be transparent and accountable, we ourselves have to be transparent and accountable. We will do this within the confines of Section 59 of the Securities and Futures Commission Ordinance, where we are obliged to keep regulatory information provided by the regulated persons and institutions confidential. I have already offered to the Financial Affairs Panel of the Legislative Council that we will make half-yearly reports on our work and be accountable to the public for our activities and efficiency. We will report as and when invited. We will make more of our work easily accessible and understandable to the community, through our Website and our investor education unit. We will work on raising the standards of professionalism through close co-operation with the Hong Kong Securities Institute and the professional bodies.

In the conduct of our work, the question of independence has sometimes been raised. As far as I know, there is no commonly accepted definition of the independence of securities regulators. However, coming from the central banking tradition, I think the dictum that central banks are not independent **of** government, but independent **within** government, aptly applies also to the business of securities regulation. Even that independence within government and within society cannot be fully enshrined within the law, but has to be earned and endowed by society at large. IOSCO feels that "the regulator should be operationally independent and accountable in the exercise of its functions and powers". To borrow again from the central banking analogy, the independence of any institution is only as strong as the integrity, competence and professionalism of its staff. We need to provide objective advice and objective execution of our duties as well as being accountable in order to earn our autonomy and credibility.

It may be useful to remind ourselves that financial regulators are not in the popularity business. Much of our work are by definition unpleasant and unpopular, since rules and sanctions will necessarily affect someone's interest, and if necessary, we may have to occasionally put some people in jail. We have to do what we have to do, within the law and without fear or favour. And, we would be fully subject to the checks and balances of judicial review. I would judge my job reasonably well done if we are equally criticised by both sides of the opinion spectrum. As I told my friends before I took the job, I fully expect eggs or worse to be thrown at me. But if anyone cares to do so, let it be known that I like mine sunny side up!

To conclude, one of the most frequent questions that I have been asked in recent months is: when will the Asian crisis end? I would be foolish and unwise as a market regulator to comment on the state of the market, especially whether it is going up or down. Only the market knows. Let me just say that by nature I am an optimist about the future, a pessimist about the downside risks, and I hope, objective in the execution of my duties.

There is an awful lot of work ahead of us. But I am fully confident that with your help, support and understanding, we will keep Hong Kong in the forefront of the free markets.